The analysis of intercompany transactions between a parent company, its nonbank subsidiaries, and its bank subsidiaries is primarily intended to assess the nature of the relationships between these entities and the effect of the relationships upon the subsidiary banks. Both legal and financial ramifications of such transactions are areas of concern. Certain intercompany transactions are subject to the provisions of Section 23A and/or 23B of the Federal Reserve Act. Several types of intercompany transactions and their relevance to regulatory concern are presented below:

1. Dividends Paid by Subsidiaries to the Parent:

Dividends represent a highly visible cash outflow by subsidiaries. Should the dividend payout ratio exceed the level at which the growth of retained earnings can keep pace with the growth of assets, the subsidiary's capital ratios will deteriorate. Such dividends may also have a negative effect on the subsidiary's liquidity position.

2. Transactions with Affiliates:

Transactions with affiliates is another area of potential abuse of subsidiary banks. Regulatory concern centers on the quantitative limits and collateral restrictions on certain transactions by subsidiary banks with affiliates. Such restrictions are designed to protect subsidiary banks from the potential jeopardy involved in being used as a source of financing by affiliates, and to ensure the collectibility of extensions of credit.

Checking accounts of the parent or nonbank subsidiaries at subsidiary banks present the potential for overdrafts, which are regarded as extensions of credit to an affiliate by the subsidiary bank. Overdrafts can potentially have an adverse effect on the bank's financial condition. Interest paid and the timing of payments on savings accounts and certificates of deposit are of concern, also.

3. Fees Paid by Subsidiaries:

Management or service fees also represent cash outflows by bank subsidiaries. Such fees may be paid to the parent, the nonbank subsidiaries, or in some cases to the other bank subsidiaries. Regulatory concern focuses on whether such fees are reasonable in relation to the services rendered and on the financial impact on the bank subsidiaries.

4. Tax Allocation:

A bank holding company organization's determination of the allocation of taxes among its component companies involves questions of both the magnitude and timing of the cash flow effects. Unreasonable or untimely tax payments or refunds to the bank can have an adverse effect on the financial condition of the banking subsidiaries.

5. Purchases or Swaps of Assets:

Asset purchases or swaps between affiliates create the potential for abuse of subsidiary banks. Regulatory concern focuses on the fairness of such asset transactions, their financial impact and timing. Fairness and financial considerations include the quality and collectibility of such assets and liquidity effects. Asset exchanges may represent a mechanism to avoid regulations designed to protect subsidiary banks from becoming overburdened with nonearning assets. Improper timing or certain structurings of asset transactions can also cause them to be regarded as extensions of credit to affiliates with the potential for violations of applicable regulations and statutes.

6. Compensating Balances:

A subsidiary bank may be required to maintain excess balances at a correspondent bank which lends to other parts of the holding company organization possibly to the detriment of the bank. The subsidiary bank may be foregoing earnings on such excess funds which may adversely affect its financial condition.

7. Other Expense Allocations:

In general, a subsidiary bank should be adequately compensated for its services or for the use of its facilities and personnel by other parts of the holding company organization. Furthermore, a subsidiary bank should not pay for expenses for which it does not receive benefit.

2020.0.1 ROLE OF THE EXAMINER

In order to assess properly intercompany transactions and relationships between affiliates, the examiner must make a thorough analysis of most intercompany transactions and must have a knowledge of applicable laws, regulations, and rulings. In particular, the examiner should be familiar with sections 23A and 23B of the Federal Reserve Act.

If a subsidiary bank of a holding company is not a State member bank, the bank's primary regulator should determine the bank's compliance with pertinent banking laws. In reviewing the subsidiary bank's examination report, any violations of laws and regulations applicable to intercompany transactions should be noted. If the violation resulted from the actions of an affiliate, the affiliate's role should be identified and be subject to criticism in the inspection report.

Violations of banking laws discovered during the inspection should be brought to management's attention; however, any action or criticism levied directly on the bank should come from the bank's primary supervisor. In the inspection report, violation of banking laws should be discussed only in cases where the holding company was the cause of or a party to the violation.

2020.1.1 SECTION 23A OF THE FEDERAL RESERVE ACT

Section 23A of the Federal Reserve Act applies to all state member banks and FDIC-insured banks. In addition, section 301 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) made the provisions of the Federal Reserve Act applicable to savings associations.

Section 23A of the Federal Reserve Act is designed to prevent the misuse of a bank's resources stemming from non-arm's-length transactions with its affiliates. The statute defines ''covered transactions'' to include extensions of credit.

Section 23A restricts ''covered transactions'' as follows:

1. The aggregate amount of covered transactions between a bank and its subsidiaries and its affiliate cannot be more than 10 percent of the bank's capital stock and surplus.
2. A bank and its subsidiaries may only engage in a covered transaction with an affiliate if the aggregate amount of covered transactions of the bank and its subsidiaries with all of its affiliates will not exceed 20 percent of the bank's capital stock and surplus.
3. A bank and its subsidiaries are prohibited from purchasing low-quality assets from the bank's affiliate. A low-quality asset is any asset (1) defined as ''substandard,'' ''doubtful,'' or ''loss,'' or treated as ''other loans especially mentioned'' in the most recent report of examination prepared by either the federal or state regulatory agency; (2) carried in a nonaccrual status; (3) on which principal or interest payments are more than 30 days past due; or (4) whose terms have been renegotiated or compromised because of the deteriorating financial condition of the obligor.
4. Covered transactions between a bank and its affiliate must be on terms and conditions consistent with safe and sound banking practices.

Any transaction by a bank with any person is deemed to be a transaction with an affiliate to the extent that the proceeds of the transaction are transferred to, or used for the benefit of, the affiliate.

Transactions between a subsidiary bank and an affiliate are reviewed during the examination of the bank for compliance with sections 23A and 23B of the Federal Reserve Act and other banking regulations and statutes. If the examiner finds a violation(s) of either section 23A or section 23B of the Federal Reserve Act during the holding company inspection, the violations should be reported in the inspection report on the Violations report page.

Section 23A applies specifically to member banks; however, every bank subsidiary of a holding company is required to be an insured bank and is therefore subject to section 23A through section 18(j) of the Federal Deposit Insurance Act, which extends the provisions of section 23A to nonmember insured banks. Every savings association is subject to sections 23A and 23B because of FIRREA. Section 23A covered transactions are also subject to the provisions of section 23B of the Federal Reserve Act. However, transactions between chain banks or ''sister'' banks are not subject to section 23B. With respect to any bank within a holding company, its affiliates include, among others, its parent, the parent's subsidiaries, and other companies directly or indirectly controlled by the bank's shareholders.

An insured depository institution's capital stock and surplus for purposes of section 23A of the Federal Reserve Act (12 U.S.C. 371c) is—

1. tier 1 and tier 2 capital included in an institution's risk-based capital under the capital guidelines of the appropriate federal banking agency, based on the institution's most recent consolidated Report of Condition and Income filed under 12 U.S.C. 1817(a)(3); and
2. the balance of an institution's allowance for loan and lease losses not included in its tier 2 capital for purposes of the calculation of risk-based capital by the appropriate federal banking agency, based on the institution's most recent consolidated Report of Condition and Income filed under 12 U.S.C. 1817(a)(3).

2020.1.1.1 Definition of an ''Affiliate''

An ''affiliate'' with respect to a bank means—

1. any company that controls[1] the bank and any

1. Control is defined as the power to (1) vote 25 percent or more of the voting shares of a company, excluding situations in which the stock is controlled in a fiduciary capacity;

other company that is controlled by the company that controls the bank;
2. any bank subsidiary of the bank;
3. any company that is controlled directly or indirectly, by a trust or otherwise, by or for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, by trust or otherwise, the bank or any company that controls the bank;
4. any company in which a majority of its directors or trustees constitute a majority of the persons holding any such office with the bank or any company that controls the bank;
5. any company, including a real estate investment trust, that is sponsored and advised on a contractual basis by the bank or any subsidiary or affiliate of the bank;
6. any investment company, with respect to which a bank or any affiliate thereof is an investment adviser as defined in section 2(a)(20) of the Investment Company Act of 1940; and
7. any company that the Board determines by regulation or order to have a relationship with the bank or any subsidiary or affiliate of the bank, such that covered transactions by the bank or its subsidiary with that company may be affected by the relationship to the detriment of the bank or its subsidiary.

The definition of affiliate does not include—

1. any company, other than a bank, that is a subsidiary of a bank;
2. any company engaged solely in holding the premises of the bank;
3. any company engaged solely in conducting a safe deposit business;
4. any company engaged solely in holding obligations of the United States or its agencies or obligations fully guaranteed by the United States or its agencies as to principal and interest; and
5. any company where control results from the exercise of rights arising out of a bona fide debt previously contracted.

Nonbank subsidiaries of banks are not affiliates for purposes of section 23A.

(2) elect a majority of the directors of a company; or (3) exercise a controlling influence over a company.

2020.1.1.2 Covered Transactions

A covered transaction per section 23A of the Federal Reserve Act means—

1. a loan or extension of credit to the affiliate;
2. a purchase of or an investment in securities issued by the affiliate;
3. a purchase of assets, including assets subject to an agreement to repurchase, from the affiliate;
4. the acceptance of securities issued by the affiliate as collateral security for a loan or extension of credit; or
5. the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate.

2020.1.1.3 Collateral for Certain Transactions with Affiliates

Section 23A also restricts a bank’s investments in affiliates and the use of an affiliate’s securities as collateral for transactions with affiliates. Within the described limitations, each loan or extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of, an affiliate by a bank or its subsidiary must be secured at the time of the transaction by collateral having a market value equal to—

1. 100 percent of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit, if the collateral is composed of—
   a. obligations of the United States or its agencies;
   b. obligations fully guaranteed by the United States or its agencies as to principal and interest;
   c. notes, drafts, bills of exchange or banker’s acceptances that are eligible for rediscount or purchase by a Federal Reserve Bank; or
   d. a segregated, earmarked deposit account with the bank;
2. 110 percent of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit if the collateral is composed of obligations of any state or political subdivision of any state;
3. 120 percent of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit if the collateral is composed of other debt instruments, including receivables; or

4. 130 percent of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit if the collateral is composed of stock, leases, or other real or personal property.

2020.1.1.4 Limitations with Respect to Collateral

Banks may accept as collateral for covered transactions receivables, leases, or other real or personal property.[2] The following are limitations and collateral restrictions.

1. Any collateral that is subsequently retired or amortized shall be replaced by additional eligible collateral where needed to keep the percentage of the collateral value relative to the amount of the outstanding loan or extension of credit, guarantee, acceptance, or letter of credit equal to the minimum percentage required at the inception of the transaction.
2. A low-quality asset shall not be acceptable as collateral for a loan or extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of, an affiliate.
3. The securities issued by the bank or an affiliate of the bank shall not be acceptable as collateral for a loan or extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of, that affiliate or any other affiliate of the bank.
4. These collateral requirements are not applicable to an acceptance that is already fully secured either by attached documents or by other property having an ascertainable market value that is involved in the transaction.

2020.1.1.5 Exceptions

Except for the requirement that all transactions be on terms and conditions that are consistent with safe and sound banking practices, the provisions of section 23A are not applicable to the following:

1. Any transaction, except for the purchase of a low-quality asset, with a bank—
   a. which controls 80 percent or more of the voting shares of the bank,
   b. in which the bank controls 80 percent or more of the voting shares, or
   c. in which 80 percent or more of the voting shares are controlled by the company that controls 80 percent or more of the voting shares of the bank (banks that are affiliated in this manner are referred to as ‘‘sister’’ banks).

   Bank Insurance Fund (BIF)-insured credit card banks and savings banks are ‘‘banks’’ for purposes of section 23A. Foreign banks are not banks for purposes of section 23A, and thus transactions between domestic banks and foreign banks are not eligible for this exemption. Savings associations also are not banks for purposes of section 23A and therefore are not eligible for the exemption. FIRREA provides for a limited exemption for transactions between banks and thrifts if (1) the bank holding company owns 80 percent of the voting stock of the thrift, and (2) every thrift and bank controlled by the bank holding company complies with all applicable capital requirements on a fully phased-in basis and without reliance on goodwill.
2. Making deposits in an affiliated bank or affiliated foreign bank in the ordinary course of correspondent business, subject to any restrictions that the Board may prescribe by regulation or order.
3. Giving immediate credit to an affiliate for uncollected items received in the ordinary course of business.
4. Making a loan or extension of credit to, or issuing a guarantee, acceptance, or letter of credit on behalf of, an affiliate that is fully secured by—
   a. obligations of the United States or its agencies,
   b. obligations fully guaranteed by the United States or its agencies as to principal and interest, or
   c. a segregated, earmarked deposit account with the bank.
5. Purchasing securities issued by any company of the kinds described in section 4(c)(1) of the Bank Holding Company Act of 1956.[3]

2. Letters of credit and mortgage-servicing rights may not be accepted as collateral for purposes of section 23A.

3. This refers to the purchase of shares of a company that—

- holds or operates properties used substantially or entirely by any banking subsidiary in its operations or property acquired for such future use;
- conducts a safe deposit business;
- furnishes services to, or performs services for, the bank holding company or its banking subsidiaries; or
- liquidates assets acquired from the bank holding company

6. Purchasing assets having a readily identifiable and publicly available market quotation and purchased at that market quotation or, subject to the prohibition contained in subsection (a)(3), purchasing loans on a nonrecourse basis from affiliated banks.
7. Purchasing from an affiliate a loan or extension of credit that was originated by the bank and sold to the affiliate subject to a repurchase agreement or with recourse.

   A sale of federal funds by a subsidiary bank to an affiliate of the bank is subject to the limitations of section 23A. A transaction in federal funds involves a loan on the part of the ''selling'' bank and a borrowing on the part of the ''purchasing'' bank. A sale of federal funds by a bank to an affiliate bank, unless it is a sister bank, is subject to the quantitative and collateral limitations of section 23A.
8. A transaction between affiliated insured depository institutions if the transaction has been approved by the appropriate federal bank agency pursuant to the Bank Merger Act (effective September 11, 1992). See 12 C.F.R. 250.241 (*Federal Reserve Regulatory Service* 3–1128, 1992 FRB 867).

2020.1.1.6 Leases

Lease transactions which constitute the functional equivalent of a loan or an extension of credit may be subject to section 23A. Such lease arrangements, in effect, are equivalent to a loan by the bank and are essentially financing arrangements. Some of the characteristics which would normally cause a lease to be construed as a loan equivalent include the lessee's having responsibility for the servicing, maintenance, insurance, licensing, or risk of loss or damage, and the lessee's having the option to purchase the equipment.

2020.1.1.7 De Facto Extensions of Credit

Other transactions may constitute de facto extensions of credit by a subsidiary bank to other members of the holding company family, for example, rent subsidies or use of a bank's personnel, funds, or equipment without adequate compensation.

2020.1.1.8 Limitations of Amount—Valuations of Transactions

Section 23A(b)(7)(D) of the Federal Reserve Act defines as a covered transaction a bank's acceptance of securities issued by an affiliate as collateral security for a loan or extension of credit to any person or company. In a 1984 opinion, the staff said that, for purposes of the quantitative limit in section 23A, the value of an extension of credit that is secured in any part by securities of an affiliate is the amount of the entire loan rather than the value of securities pledged as collateral.

The staff has revised the 1984 opinion and believes that in situations in which a loan is secured by affiliate shares and other collateral, it is reasonable to reflect the fair market value of the nonaffiliate collateral in determining the applicability of the quantitative limits in section 23A to loans by a bank to an unaffiliated third party. For purposes of applying these quantitative limits, such mixed-collateral loans should be valued at the lesser of (1) the total value of the loan less the amount of nonaffiliate collateral (if any) marked to fair market value, or (2) the fair market value of the affiliate's shares that are used as collateral. Under this calculation method, if the loan is fully secured by collateral with a fair market value that equals or exceeds the loan amount (excluding the affiliate's shares), the loan would not be included in the bank's quantitative limits. If the loan is not fully secured by collateral excluding the affiliate's shares, the amount that the bank must count against its quantitative limits is the difference between the full amount of the loan and the fair market value of the nonaffiliate collateral, up to a maximum of the value of the affiliate's shares. This methodology takes account of the bank's reliance on the fair market value of nonaffiliate collateral in a loan transaction, while also recognizing that a portion of the loan may be supported by shares issued by an affiliate. If a portion of a loan is secured with nonaffiliate collateral that was marked to its fair market value, that part of the loan should not be subject to the quantitative limits of section 23A.

Under section 23A(c)(4), the securities issued by an affiliate are not acceptable collateral for a loan or extension of credit to any affiliate. Moreover, if the proceeds of the loan that are secured by the affiliate's shares are transferred to an affiliate by the third-party borrower to purchase

or its banking subsidiaries or those that were acquired from any other source before May 9, 1956, or the date upon which the company became a bank holding company, whichever is later.

assets or securities from the affiliate, the loan is treated as a loan to the affiliate. The loan must then be secured with collateral in an amount and of a type that meets the requirements of section 23A for loans by a bank to an affiliate (see *Federal Reserve Regulatory Service* 3–1167.3). Moreover, a loan that is secured with any amount of an affiliate's shares must be consistent with safe and sound banking practices.[4]

2020.1.1.9 Contributing Shares or Assets of a BHC Affiliate to a Bank

The holding company's contribution to a bank of the shares or assets of an affiliate may result in a "purchase of assets" under section 23A to the extent that consideration is given by the bank for the shares or assets it receives. The consideration may be given in the form of cash, a note booked by the bank as a receivable, or the assumption by the bank of the nonbank's liabilities owed to another affiliate. In addition, a bank's assumption of a liability to an unaffiliated party may also raise supervisory concerns. These transactions warrant particular scrutiny to ensure compliance with section 23A and to ensure that the transfer is not indicative of a broader liquidity problem with the holding company.

2020.1.2 SECTION 23B OF THE FEDERAL RESERVE ACT

Section 23B of the Federal Reserve Act became law on August 10, 1987, as part of the Competitive Equality Banking Act of 1987. This section also regulates transactions with affiliates. Section 23B applies to any covered transaction with an affiliate, as that term is defined in section 23A, but excludes banks from the term "affiliate." Section 301 of the Financial Institutions Reform, Recovery, and Enforcement Act made section 23B of the Federal Reserve Act, as well as section 23A, applicable to savings associations. The transactions covered by section 23B consist of the following:

1. Any covered transaction with an affiliate. Any transaction by a bank or its subsidiary with any person is deemed to be a transaction with an affiliate of the bank if any of the proceeds of the transaction are used for the benefit of, or transferred to, the affiliate.
2. The sale of securities or other assets to an affiliate including assets subject to an agreement to repurchase.
3. The payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise.
4. Any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person.
5. Any transaction or series of transactions with a third party if—
   a. an affiliate has a financial interest in the third party, or
   b. an affiliate is a participant in such transaction or series of transactions.

A bank and its subsidiaries may engage in the transactions covered by section 23B of the Federal Reserve Act, but only on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the bank or its subsidiary, as its transactions with or involving nonaffiliates.

Section 23B restricts transactions with affiliates in the following situations:

1. A bank or its subsidiary cannot purchase as fiduciary any securities or other assets from any affiliate unless the purchase is permitted (1) under the instrument creating the fiduciary relationship, (2) by court order, or (3) by law of the jurisdiction.
2. A bank or its subsidiary cannot knowingly purchase or acquire any security during the existence of an underwriting or selling syndicate, if an affiliate of the bank is a principal underwriter, unless the purchase has been approved before the sale to the public by a majority of the bank's outside directors.

A bank or any subsidiary or affiliate of a member bank cannot publish any advertisement or enter into any agreement stating or suggesting that it shall in any way be responsible for the obligations of its affiliates.

2020.1.3 INSPECTION OBJECTIVES

1. To analyze and assess the financial impact of transactions (including loans and purchases of assets) between the subsidiary banks and their subsidiaries and all affiliates.
2. To determine whether transactions between a subsidiary bank (and its subsidiaries) and its

4. Staff opinion of January 21, 1999 (*Federal Reserve Regulatory Service* 3–1199).

affiliates in the holding company are restricted to the range of covered and permissible transactions cited within sections 23A and 23B of the Federal Reserve Act.
3. To determine if transactions between a subsidiary bank and its affiliates in the holding company are on terms and conditions and under circumstances, including credit standards, that are consistent with safe and sound banking practices and whether the terms and conditions of the transactions are the same as those that would be offered or applied to nonaffiliated companies.
4. To determine whether a subsidiary bank or its subsidiary has purchased low-quality assets or has purchased, as fiduciary, any securities or other assets from an affiliate in the holding company.
5. To determine whether a subsidiary bank, or any subsidiary or affiliate of the bank, has published any advertisement or has entered into any agreement that states or suggests that it will, in any way, be responsible for the obligations of affiliates.
6. To determine if securities were purchased or acquired by the subsidiary bank or its subsidiaries from an underwriting or selling syndicate affiliated with the bank and, if so, if the majority of outside directors of the bank approved the purchase or acquisition of securities before they are offered for sale to the public.
7. To confirm that the subsidiary bank or its subsidiary has not purchased as fiduciary any securities or other assets from a nonbank affiliate in the holding company unless the purchase was permitted in accordance with the instrument creating the fiduciary relationship, by court order, or by the law governing the fiduciary relationship.
8. To ascertain if any subsidiary bank (or its subsidiary) had knowingly purchased or acquired any security from an affiliate where the principal underwriter of that security was a nonbank affiliate within the holding company organization.
9. To determine if the subsidiary bank and its subsidiaries have conducted transactions with their parent holding company or any other company affiliated in the holding company organization that are not in compliance with the restrictions found in sections 23A and 23B of the Federal Reserve Act (for FDIC-insured nonmember banks, section 18(j) of the Federal Deposit Insurance (FDI) Act).

2020.1.4 INSPECTION PROCEDURES

1. During the preinspection, perform the following activities:
   a. Review examination reports of subsidiary banks for comments on loans to affiliates, intercompany transactions, other transactions with affiliates, and violations of the restrictions of sections 23A or 23B of the Federal Reserve Act or, for FDIC-insured nonmember banks, section 18(j) of the FDI Act.
   b. Review the most current FR Y-8 and FR Y-8f (Report of Intercompany Transactions) and interim reports for information on transactions with affiliates.
2. In the officer's questionnaire, request a list of subsidiary bank (and the subsidiaries of the bank) transactions with affiliates since the previous inspection, including the terms and any collateral, consisting of—
   a. a loan or extension of credit to the affiliate;
   b. a purchase or sale of an investment in securities issued by or sold to the affiliate, or a purchase or sale of other assets, including assets subject to an agreement to repurchase;
   c. the acceptance of securities issued by the affiliate as collateral security for a loan or extension of credit;
   d. the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit on behalf of an affiliate;
   e. the payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise;
   f. transactions in which an affiliate acts as agent or broker or receives a fee for its services to the bank or to any other person;
   g. any transaction or series of transactions with a third party if—
      - the affiliate has a financial interest in the third party, or
      - the affiliate is a participant in such transactions; and
   h. any transaction by a subsidiary bank or its subsidiary with any person, if the proceeds of that transaction are used for the benefit of, or transferred to, the affiliate.
3. During the inspection, perform the following activities:

a. Review the listed transactions with affiliates provided in response to the officer's questionnaire.
b. Review and determine that all transactions within the holding company organization comply with the restrictions on transactions with affiliates found in sections 23A and 23B of the Federal Reserve Act (section 18(j) of the FDI Act for FDIC-insured nonmember banks).
c. Review all related documentation, terms, and conditions, and circumstances for each transaction, including any resolutions for securities purchased (or established standards for securities purchased from affiliates).
d. Determine the purpose and use of the proceeds.
e. Review all outstanding guarantees, endorsements, or pledge agreements by the bank to support the affiliates' borrowings.
f. Review, on a test-sample basis, advertisements and written agreements to ascertain whether the bank or any subsidiary or affiliate of the bank has stated or suggested that it shall be responsible for the obligations of any affiliates in the holding company organization.
g. Review the holding company's policies and procedures regarding intercompany transactions of subsidiary banks.

4. Give additional attention to the following problems involving the BHC and its subsidiaries:
   a. The subsidiary bank would not have made the loan or made the loan with such favorable terms and conditions, or engaged in any other covered transaction, except for the parent holding company's insistence due to the affiliate relationship.
   b. The bank's condition is weakened due to the extension of credit or the nature of the transaction with the affiliate.
   c. The affiliate has not provided adequate qualifying collateral to support the loan or extension of credit provided by the subsidiary bank.
   d. The loan, extension of credit, or transaction with an affiliate is not in compliance with the limits and restrictions found in sections 23A or 23B of the Federal Reserve Act.
   e. Purchases of low-quality assets by a subsidiary bank or its subsidiaries from an affiliate, unless previously exempted by Board regulation or order, or unless the bank subsidiary or subsidiary affiliate, pursuant to an independent credit evaluation, had not committed itself to purchase the low-quality assets prior to the time such asset was acquired by the affiliate.
   f. During the existence of any underwriting or selling syndicate, a subsidiary bank or its subsidiary has purchased or acquired a security from a bank affiliate or bank holding company affiliate, including a section 20 company, when the principal underwriter of that security is an affiliate of the bank.
   g. The purchase or acquisition of securities was not approved by the majority of the outside board of directors before the securities were offered for sale to the public and were not, in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would have been offered to, or would have applied to, nonaffiliated companies.
   h. The existence of advertisements or agreements that state or suggest that the bank, its subsidiaries, or affiliate will be responsible for the obligations of its affiliates.
5. Review any checking accounts and bank statements for overdrafts the parent company or any of its nonbank subsidiaries may have with a subsidiary bank.
6. Review the accounts payable to the subsidiary bank(s) and other accounts payable accounts for servicers, contractors, lessors, and other affiliates to determine if they arose as the equivalent of an extension of credit, purchase of securities or other assets, or as a liability to third parties. Ascertain whether those transactions were listed in response to the officer's questionnaire, and whether the transactions were in accordance with the restrictions found in sections 23A and 23B of the Federal Reserve Act.
7. Review the accounts receivable from the subsidiary bank(s) and other accounts receivable of other affiliates for sales of securities or other assets, and the payment of money or the furnishing of services. Ascertain whether those transactions were reported in response to the officer's questionnaire and whether they are in accordance with the section 23A and 23B restric-

tions placed on transactions with affiliates.

8. Review all other transactions that the holding company organization has engaged in with its affiliated bank(s) and their subsidiaries, including lease arrangements, to determine whether they are subject to the restrictions found in sections 23A and 23B, and, if so, whether they are in compliance therewith.
9. Discuss the findings with appropriate management personnel.
10. a. Determine management's actions regarding any comments raised by the bank's primary regulator in an examination report. If violations are disclosed in a subsidiary bank's examination report or during an inspection of the holding company, the examiner may criticize management on the Examiner's Comments and Matters Requiring Special Board Attention page of the inspection report for causing the bank to be in violation or for engaging in unsafe and unsound practices.
    b. If loans to or transactions with affiliates within the holding company organization appear to adversely affect a subsidiary bank, request management's assessment of such effects and its rationale for the transactions. Use of the Examiner's Comments and Matters Requiring Special Board Attention report page may be appropriate.

2020.1.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*FRRS*[3]	*Orders*
Definition of affiliate, subsidiary, bank, company, and ''covered transaction''	371c, FRA section 23A(b)		3–1111	
Limitations and collateral requirements	371c, FRA section 23A(c)		3–1112 3–1199	
Applicability to FDIC-insured banks	1828(j), FDI Act section 18(j)		1–398	
Restrictions on transactions with affiliates	371c-1, FRA section 23B		3–1116	
Undivided profits as part of ''capital and surplus''		250.162	3–1505.1	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

It is common practice for a bank to sell to or place with other banks loans that the bank itself has made to its customers. A loan participation is a share or part of a loan which entitles the holder to a pro rata share of the income determined by the extent of the holder's contribution to the original loan and a preference ordering for repayment. Such loans may be sold outright without liability to the selling bank in case of default by the borrower, or they may be sold with terms granting the purchasing bank recourse to the selling bank should the loans become uncollectible. Sales to or placement of loans with other banks are for the accommodation of either the selling or purchasing bank and are arranged for purposes of increasing the rate of return when loan rates differ between banks, achieving diversification of loans by type, and altering liquidity positions. It is also common practice for banks to sell or place with other banks those portions of individual loans that would be in excess of the bank's legal lending limit (overlines) if the total loan were retained. Participations of this type should be placed without recourse as a matter of prudent banking practice; otherwise, the purpose of compliance with the legal lending limitations would be defeated in the event of default.

Banks also sell or place loans or participations with their parent holding companies or nonbank affiliates. A BHC's purchase of loan participations from its subsidiary bank(s) generally constitutes the making of a loan or extension of credit within the meaning of section 225.28(b)(1) of Regulation Y, and as such, a bank holding company needs prior approval to purchase loan participations from its subsidiary bank(s).

A bank may participate in or purchase a loan originated by its parent holding company or one of its nonbank subsidiaries. A subsidiary bank's purchase, or participation of a loan, note, or other asset from an affiliate is considered a purchase of an asset from an affiliate within the meaning of section 23A of the Federal Reserve Act and thus is a ''covered transaction'' that is subject to the quantitative limitations and the prohibition against purchasing of low-quality assets. Subsidiary banks must make independent judgments as to the quality of such participations before their purchase to avoid compromising the asset quality of such banks for the benefit of other holding company entities. All loans and participations must be purchased on market terms.

A bank's purchase of a loan or loan participation from a bank holding company or its subsidiary may not be a covered transaction under section 23A if (1) the bank makes an independent credit evaluation on each loan prior to the affiliate making the loan, (2) the bank agrees to purchase the loan prior to the affiliate making the loan, and (3) the bank's purchase of the affiliate's loans is not the primary source of funding for the affiliate.

In some cases, a bank may renew a loan or a participation that it purchased from another affiliated bank even when the original participation has become a low-quality asset. In some instances, a bank's renewal of a low-quality asset, such as a troubled agricultural loan, or an extension of limited amounts of additional credit to such a borrower may enable both the originating and participating banks to avoid or minimize potential losses. It would be inconsistent with the purposes of section 23A to bar a participating bank from using sound banking judgment to take the steps that it may deem necessary to protect itself from harm in such a situation, so long as the loan was not a low-quality asset at the time of the original participation and the participating bank does not assume more than its original proportionate share of the credit.

The following factors thus characterize the situation where it would be reasonable to interpret section 23A as not applying to the renewal of an otherwise low-quality asset:

1. the original extension of credit was not a low-quality asset at the time the affiliated bank purchased its participation,
2. the renewal and/or the extension of additional credit has been approved by the board of directors of the participating bank as necessary to protect the bank's investment by enhancing the ultimate collection of the original indebtedness, and
3. the participating bank's share of the renewal and/or additional loan will not exceed its proportionate share of the original investment. In addition, it is expected that, consistent with safe and sound banking practices, the originating bank would make its best efforts to obtain adequate collateral for the loan(s) to further protect the banks from loss.

Loans and loan participations by the various members of the holding company family to individual borrowers or to the same or related interests may represent concentrations of credit which are large in relation to the holding company's consolidated capital position. These concentrations of credit should be assessed for potentially harmful exposure to the holding company's financial condition.

2020.2.1 INSPECTION OBJECTIVES

1. To determine the bank holding company's loan participation policy.
2. To assess the impact of a subsidiary bank's participation in loans with affiliates and to ensure that the bank's financial condition is not compromised and that the bank is not providing the funding needs of the affiliates, except within the parameters of sections 23A and 23B of the Federal Reserve Act.
3. To assess the impact of any concentrations of credit on the holding company's overall financial position.

2020.2.2 INSPECTION PROCEDURES

1. During the preinspection process, review each subsidiary bank's examination report for comments on participations with affiliates.
2. In the officer's questionnaire to the holding company, request the BHC's policy on loan participation. Request a list of any loan participations the holding company or the nonbank subsidiaries have with the subsidiary bank(s).
3. During the inspection, review the policy statements and each participation the holding company or the nonbank subsidiaries have with the subsidiary bank(s). The following characteristics should be analyzed:
   a. any repetitive transaction patterns which may indicate policy;
   b. the adequacy of credit information on file;
   c. the extent to which the terms of the participation including interest rates are handled in an arm's-length manner;
   d. the degree that the bank is accommodating the funding needs of the nonbank subsidiaries or its parent;
   e. the impact of these transactions on the subsidiary bank;
   f. eligibility for exclusion from section 23A restrictions and, if applicable, compliance with such restrictions.
4. Review participations among the bank holding company, nonbank subsidiaries, and the subsidiary banks to determine potentially adverse concentrations of credit.
5. Discuss with management—
   a. written and verbal policies regarding participations both within the holding company and with nonaffiliated third parties and
   b. any adverse findings on intercompany participations.
6. Comment on policy on the appropriate page of the inspection report (see section 5010.6). If any adverse comments on participations with affiliates are contained in a bank subsidiary's examination report, comment on their current status and the bank holding company's efforts to remedy the problem.

2020.2.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Limitations and restrictions	Section 23A(c), FRA 371c			
Purchase of loans from mortgage banking affiliates		250.250	3–1133	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Sales and transfers of assets between subsidiary banks and other entities in a bank holding company organization pose the potential of risk to the subsidiary banks. Asset purchases are covered by Section 23A and Section 23B of the Federal Reserve Act. The limitations state that all covered transactions, including asset purchases, by a bank with a single affiliate, may not exceed 10 percent of a bank's capital and surplus, and transactions with all affiliates may not exceed 20 percent of the bank's capital and surplus. In addition, all transactions must be conducted on market terms.

A bank's purchase of a loan or loan participation from a bank holding company or its subsidiary may not be a covered transaction under Section 23A if:

1. the bank makes an independent credit evaluation on each loan prior to the affiliate making the loan;
2. the bank agrees to purchase the loan prior to the affiliate making the loan; and
3. the bank's purchase of the affiliate's loans is not the primary source of funding for the affiliate.

Sale and transfer of assets can also occur through swaps and spinoffs. Examples of such transactions which may have an adverse effect on a bank include the transfer of a profitable activity or subsidiary from the bank to the holding company, or the transfer of an unprofitable activity or subsidiary from the holding company to the bank. In addition, the transfer of a bank holding company subsidiary to a bank, whereby the bank assumes the liabilities of the affiliate raises supervisory concerns and may violate Sections 23A and 23B of the Federal Reserve Act.

Another example is the transfer of a subsidiary bank's deferred taxes, together with an equivalent amount of cash or earning assets, to the parent. In such a transaction, a subsidiary bank's liquidity position is weakened. All such transfers of deferred taxes must be reversed and the bank's asset and liability accounts restored to their level prior to the transfer. For a detailed discussion on transfers of a bank's deferred tax liability, see Manual section 2070.0.

A bank holding company may transfer a liquidating asset from a subsidiary bank to a section 4(c)(1)(D) liquidating subsidiary of the holding company. Also, pursuant to section 4(c)(3) of the Act, a BHC may transfer from a subsidiary bank an asset to be disposed of pursuant to the request of the bank's primary regulator. For more information on the transfer of such assets and the time parameters involved, refer to Manual section 3030.0.

The purchase of low-quality assets is prohibited by Section 23A of the Federal Reserve Act. Refer to section 2020.1.1.5 for a listing of transactions that are exempt from the limitations of Section 23A of the Federal Reserve Act.

2020.3.1 INSPECTION OBJECTIVES

1. To review intercompany sale and transfer of assets to assess the impact on the subsidiary bank.
2. To initiate corrective action to reverse the transaction, if necessary.

2020.3.2 INSPECTION PROCEDURES

1. During the preinspection process, review all notes to financial statements, the FR Y-8 report, and the examination reports of subsidiary banks to ascertain whether any purchase or transfer of assets has occurred between the subsidiary banks and the parent holding company or nonbank subsidiaries.
2. In the officer's questionnaire, request information on any transfer or sale of assets between the subsidiary bank and the parent holding company or the nonbank subsidiaries.
3. During the inspection, review all facts regarding any sale or transfer of assets transactions and assess their impact on the subsidiary bank. Examiners should determine:
    a. Whether the transaction required and received the approval of the bank's primary regulator; and
    b. The quality of the assets transferred or sold, and whether the sale of the assets was at a price significantly higher than would have been realized in an arm's-length transaction.
4. Discuss findings with management including:
    a. Apparent prejudicial transactions and violations of regulations; and
    b. Any unsound practices.

A compensating balance is a deposit maintained by a firm at a bank to compensate the bank for loans and lines of credit granted to the firm. Often, a commercial bank, when extending credit, requires an average deposit balance equal to a fixed percentage of the outstanding loan balance. Compensating balance requirements vary from informal understandings to formal contracts. Deposits maintained as compensating balances may be demand or time, active or dormant. Frequently, a lending bank will allow compensating balances to be supplied by a depositor other than the borrower itself. If compensating balances are maintained by a BHC's subsidiary bank on behalf of its parent, the practice is considered a diversion of bank income (i.e., the bank loses the opportunity to earn income on the balances that could be invested elsewhere). In general, this practice is inappropriate unless the bank is being compensated at an appropriate rate of interest. If the bank is not being appropriately reimbursed, the practice should be criticized and action taken to insure that the bank is compensated for the use of its funds.

BHCs borrow directly from nonaffiliated banks, using the proceeds for both bank and nonbank operations and investments. Also, bank holding companies seek credit lines from banks to back their borrowings in commercial paper markets and for other liquidity purposes. Nonbank subsidiaries of bank holding companies borrow from banks to fund activities such as mortgage banking, leasing and sales finance. In some cases, when a bank holding company or its nonbank subsidiaries borrow, the subsidiary bank's deposit at the lending institution may be accepted as a compensating balance for the borrowings of other members of the bank holding company organization. Such transactions raise questions under Section 23B of the Federal Reserve Act regarding the bank's compensation for such services.

Often the distinction between correspondent balances and compensating balances is not clear. Occasionally, the rate of the required compensating balance is written into the loan agreement; however, informal understandings usually appear to determine the amount of compensating balance maintained. At times, a balance may be identified in the bank's books as a compensating balance. A compensating balance may also be identified as an amount above a correspondent balance historically maintained by the bank. Compensating balances may also appear as a dormant account or may be the aggregate amount of a number of deposits of various subsidiary banks.

The interest rate on the loan to the holding company organization may also be helpful in determining the existence of compensating balances. Loans below the lending bank's normal rate may indicate that the lending bank is receiving compensation in another form.

At times, excess correspondent balances are maintained to encourage participation relationships and for other goodwill reasons. Therefore, the existence of excess balances may not always indicate that there is a compensating balance agreement.

Although a bank holding company may compensate its subsidiary banks for the use of the funds, the compensation may not equal the opportunity cost associated with providing the compensating balance. As a result, subsidiary banks which maintain compensating balances for holding company members may forego profit opportunities, and this practice may have a negative impact on the bank's earnings and capital adequacy. The amount of such compensation should be equal to a fair market rate.

If the lending bank has the right of offset to compensating balances maintained by the subsidiary bank in case of default by parent or nonbank subsidiaries, the subsidiary bank's funds are jeopardized. Such potential loss of funds should be commented on by the examiner.

2020.4.1 INSPECTION OBJECTIVES

1. To identify compensating balances maintained by a subsidiary bank for the parent holding company or any nonbank affiliate.
2. To determine whether the subsidiary bank is adequately reimbursed for the maintenance of any compensating balances.

2020.4.2 INSPECTION PROCEDURES

1. During the preinspection process:
   a. Review the subsidiary bank examination reports or contact management to determine whether the non-affiliated banks, lending to the holding company organization, are correspondents of the subsidiary banks. Where applicable, request detailed loan information which could

provide information on the compensating balances' terms required by the lending bank.

b. Review the notes to the financial statements and other available material, such as 10–K reports filed with the SEC, which may describe compensating balance agreements. FR Y–8 reports should be reviewed for questions applicable to compensating balances.

2. Review interbank loan agreements to determine whether compensating balances are formally required. Assess the terms of the loan to determine whether the loan appears to be at fair market rates for this type of credit request.

3. Request and review the account balance and monthly account statement provided by the lending bank to identify the amount of compensating balances. The statement should be available within the holding company or bank.

4. Request from management information regarding compensating balances maintained by subsidiary banks for the benefit of other affiliates.

5. Review the subsidiary bank's historical level of correspondent balances to assess trends. Compare levels of balances prior to any loan origination or interest rate changes.

6. Review intercompany accounts to determine the amount of compensation paid to the subsidiary bank for maintaining compensating balances. Assess adequacy of compensation. Assess impact of practice on the bank's financial condition.

7. Discuss with management the reasons for any apparent excess balances, and whether compensating balances are formally or informally required.

Dividends are a means by which a corporation distributes earnings or assets to its shareholders. Although the word ‘‘dividends’’ usually applies to funds paid out of net profits or surplus and is usually thought of in such a context, dividends can also be made ‘‘in kind,’’ which means in property or commodities. This section does not discuss ‘‘stock dividends’’ which represent transfers from retained earnings to paid-in capital rather than distributions of earnings. Dividends from the subsidiaries, both bank and nonbank, to the parent company are the means by which a cash return is realized on the investment in subsidiaries, thus enabling the parent to pay dividends to its shareholders and to meet its debt service requirements and other obligations.

Dividends paid by any corporation are generally limited by certain State laws. Banks, however, are subject to further legal restrictions on dividends by their chartering authority and other regulators. Aside from the statutory limitations, the primary consideration in this area is the subsidiary’s level of capital and its ability to meet future capital needs through earnings retention.

Although there are no specific regulations restricting dividend payments by bank holding companies other than State corporate laws, supervisory concern focuses on the holding company’s capital position, its ability to meet its financial obligations as they come due, and its capacity to act as a source of financial strength to its subsidiaries. Some one-bank holding companies may be restricted in the amount of dividends they may pay as a result of certain limitations placed on future dividend distributions at the time of the holding company’s formation. (see Manual section 2090.2)

When analyzing the dividend practices of the subsidiaries and the parent company the following must be considered: the present level of capital in relation to total assets, risk assets, and classified assets; growth rates and additional plans for expansion; past earnings performance and projections; and the ability to service debt.

Aside from reasonable and timely fees for services rendered, the most appropriate way for funds to be paid by the bank to the parent is through dividends. This principle applies, in general, to bank payments of funds to service holding company debt, even when the debt was initially incurred to raise equity capital for the subsidiary bank. It is not considered an appropriate banking practice for the subsidiary bank to pay management fees for the purpose of servicing holding company debt. Funds for servicing holding company debt should, as a general rule, be upstreamed in the form of dividends.

2020.5.1 POLICY STATEMENT ON CASH DIVIDEND PAYMENTS

On November 14, 1985 the Board approved a policy statement on the payment of cash dividends by state member banks and *bank holding companies that are experiencing financial difficulties.* The policy statement addresses the following practices of supervisory concern by institutions that are experiencing earnings weaknesses, other serious problems, or that have inadequate capital:

- The payment of dividends not covered by earnings,
- The payment of dividends from borrowed funds,
- The payment of dividends from unusual or nonrecurring gains, such as the sale of property or other assets.

It is the Federal Reserve’s view that an organization experiencing earnings weaknesses or other financial pressures should not maintain a level of cash dividends that exceeds its net income, that is inconsistent with the organization’s capital position, or that can only be funded in ways that may weaken the organization’s financial health. In some instances, it may be appropriate to eliminate cash dividends altogether. The policy statement is as follows:

2020.5.1.1 Policy Statement on the Payment of Cash Dividends by State Member Banks and Bank Holding Companies

The Board of Governors of the Federal Reserve System considers adequate capital to be critical to the health of individual banking organizations and to the safety and stability of the banking system. A major determinant of a bank’s or bank holding company’s capital adequacy is the strength of its earnings and the extent to which its earnings are retained and added to capital or paid out to shareholders in the form of cash dividends.

Normally, during profitable periods, dividends represent an appropriate return of a portion of a banking organization's net earnings to its shareholders. However, the payment of cash dividends that are not fully covered by earnings, in effect, represents the return of a portion of an organization's capital at a time when circumstances may indicate instead the need to strengthen capital and concentrate financial resources on resolving the organization's problems.

As a matter of prudent banking, therefore, the Board believes that a bank or bank holding company generally should not maintain its existing rate of cash dividends on common stock unless 1) the organization's net income available to common shareholders over the past year has been sufficient to fully fund the dividends *and* 2) the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality, and overall financial condition. Any banking organization whose cash dividends are inconsistent with either of these criteria should give serious consideration to cutting or eliminating its dividends. Such an action will help to conserve the organization's capital base and assist it in weathering a period of adversity. Once earnings have begun to improve, capital can be strengthened by keeping dividends at a level that allows for an increase in the rate of earnings retention until an adequate capital position has been restored.

The Board also believes it is inappropriate for a banking organization that is experiencing serious financial problems or that has inadequate capital to borrow in order to pay dividends since this can result in increased leverage at the very time the organization needs to reduce its debt or increase its capital. Similarly, the payment of dividends based solely or largely upon gains resulting from unusual or nonrecurring events, such as the sale of the organization's building or the disposition of other assets, may not be prudent or warranted, especially if the funds derived from such transactions could be better employed to strengthen the organization's financial resources.

A fundamental principle underlying the Federal Reserve's supervision and regulation of bank holding companies is that bank holding companies should serve as a source of managerial and financial strength to their subsidiary banks. The Board believes, therefore, that a bank holding company should not maintain a level of cash dividends to its shareholders that places undue pressure on the capital of bank subsidiaries, or that can be funded only through additional borrowings or other arrangements that may undermine the bank holding company's ability to serve as a source of strength. Thus, for example, if a major subsidiary bank is unable to pay dividends to its parent company—as a consequence of statutory limitations, intervention by the primary supervisor, or noncompliance with regulatory capital requirements—the bank holding company should give serious consideration to reducing or eliminating its dividends in order to conserve its capital base and provide capital assistance to the subsidiary bank. . . .

This statement of principles is not meant to establish new or rigid regulatory standards; rather, it reiterates what for most banks, and businesses in general, constitutes prudent financial practice. Boards of directors should continually review dividend policies in light of their organizations' financial condition and compliance with regulatory capital requirements, and should ensure that such policies are consistent with the principles outlined above. Federal Reserve examiners will be guided by these principles in evaluating dividend policies and in formulating corrective action programs for banking organizations that are experiencing earnings weaknesses, asset quality problems, or that are otherwise subject to unusual financial pressures.

2020.5.2 INSPECTION OBJECTIVES

1. To assure compliance with statutes and the Board's November 1985, Policy Statement.
2. To determine reasonableness of dividend payout at both the subsidiary and holding company levels.

Depending on the type of charter and membership in the Federal Reserve, all insured commercial banks are subject to certain legal restrictions on dividends. In the case of nonbank subsidiaries and holding companies, there are no specific federal statutes, other than the policy statements discussed, which apply to dividend payments. State corporate laws would apply. One objective of the inspection process is to check for compliance with these laws and to follow-up on any violations.

In some cases dividends which comply with the regulations still may not be in the best interest of the bank. It is the examiner's responsibility to assess the reasonableness of dividend payments in relation to each subsidiary's capital needs. Evaluation of the holding company's dividend policy and payment requires a review at both the parent company and the consolidated levels. On a consolidated basis the holding company's capital level in relation to the quantity and quality of total assets, earnings history and potential, and growth rates are important in the assessment of a reasonable dividend payout. At the parent level, the method of funding dividends should be reviewed. For example, a well capitalized corporation with strong earnings might pay dividends which could be considered unreasonable if the organization were in a strained liquidity position.

2020.5.3 INSPECTION PROCEDURES

1. Review dividend payments by subsidiaries and the parent company. Check for compliance with appropriate statutes and the Board's November 14, 1985 policy statement on the Payment of Cash Dividends. Discuss violations with management and comment on the ''Examiner's Comments'' page.

This step will often require a review of net earnings and changes in the capital accounts in the past years, as legal restrictions on dividends often apply to cumulative income for several years rather than just the year the dividend is actually paid. For this reason detailed working papers are important, as these can help to avoid duplications of effort at future inspections. In some situations the regulations provide that dividends may be paid in excess of current year's earnings. If prior approval from the bank's primary regulator is necessary, verify that it has been obtained. Any violations of dividend statutes should be discussed with management and cited in the ''Examiner's Comments'' page of the inspection report.

2. Analyze dividend payouts of subsidiaries and the parent in terms of capital adequacy, earnings and earnings potential.

Discuss excessive dividend payouts at any level with management and comment on the ''Examiner's Comments'' page of the inspection report. In assessing the reasonableness of dividend payments by subsidiaries and the holding company, the organization's capital adequacy and future capital needs must be judged with the following in mind: the volume of total assets; asset quality (the percentage of weighted classified assets to gross capital could be used as an indicator of quality); asset mix and liquidity; asset growth rates and projections; and plans for expansion and development of new areas. The subsidiary's or the holding company's ability to augment capital through earnings is also important. If a bank, nonbank or holding company has a consistently strong earnings record and its capital position is healthy, a higher dividend payout may be acceptable than would be otherwise. In analyzing the strength of earnings both quantity and quality must be considered. The actual quality of earnings and earnings potential are related to operating income rather than extraordinary items, significant capital or securities gains, or substantial increases resulting from tax considerations.

3. Review the funding of dividends paid by the holding company. Analyze the parent's cash flow and income statements in accordance with section 4010.0 of this manual. Discuss any inappropriate funding with management and comment on, based on their severity, either on the ''Cash Flow Statement (Parent),'' or the ''Analysis of Financial Factors'' and the ''Examiner's Comments'' pages.

An analysis of the parent company's cash flow statement supplemented by the income statement will identify the source of cash for dividend payments. The parent company has cash inflow from various sources including: dividends from subsidiaries, income from activities conducted for its own account, interest income on advances to subsidiaries, management and service fees, borrowings, and tax savings resulting from filing a consolidated tax return. Dividends should be internally funded from dividends paid by the subsidiaries, the parent company's earnings from activities for its own account or from interest income on advances to subsidiaries. Should the analysis of the cash flow statement indicate that dividends paid by the parent exceed cash inflow from these sources, further attention to the area is required to determine the actual underlying source of dividend funding. As discussed in the section on management and service fees, these are properly assessed at market value or cost of services rendered. They are not to be charged simply to divert income from subsidiaries in order to pay dividends. Borrowing to fund dividends is fundamentally an unsound practice.

When dividends paid by the holding company are funded by the bank subsidiary, it is possible to control indirectly the holding company's dividend payout level when it is determined to be detrimental to the bank subsidiary. It is important to remember that the primary responsibility of bank regulators is the promotion of safe and sound banking operations. Other than the mentioned policy statement there are no specific federal laws restricting dividends paid by bank holding companies; however, the System's cease and desist authority over bank holding companies does afford the ability to curb excessive dividend payouts.

Whenever the examiner determines that dividend payments at the subsidiary level or parent level are not reasonable, are not in the best interest of the organization, or are not funded in a proper manner, discussion with management and a close look at its philosophy are essential. Remarks on the matter should appear on the ''Examiner's Comments'' page of the report.

2020.5.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Dividend limits for national banks	5199(b) R.S.A.			
Dividend limits	5204 R.S.A.			
Dividend limits for State member banks	Section 9, F.R. Act			
Capital limitations and earnings limitations on the payment of dividends by state member banks		208.19	3–400.81	
Board policy statement on assessment of financial factors, one bank holding companies (para. 4 dividend restrictions)			4–855	1980 FRB 320
Board policy statement on dividends for banking organizations having financial difficulties			4–877	1986 FRB 26

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

A bank holding company is permitted to own nonbank subsidiaries that furnish services to or perform services for its other subsidiaries pursuant to section 4(a)(2)(A), 4(c)(1)(C), or 4(c)(8) of the BHC Act. Many bank holding companies charge fees for providing to their subsidiaries services such as management advice, personnel services, data processing, marketing, supply administration, investment advice, bookkeeping, and trust services. The fees for these services that are assessed against subsidiary banks take many forms and are an area of potential abuse. In addition to direct fees paid to an affiliate, the compensation for providing these services might take the form of salaries or directors' fees paid to the bank holding company's management. A holding company should not, directly or indirectly through other subsidiaries, burden its bank subsidiaries with excessive fees or charge for services unrelated to value received in order to fund its debt service, dividend payments, or support of other subsidiaries.

Examiners should review the fees charged by a holding company's bank and nonbank subsidiaries to any banking subsidiary and judge the reasonableness of those fees by examining the reasonableness of the services provided and the basis for allocating fees. Fees charged nonbank subsidiaries and independent third parties should not be more favorable than fees charged banking subsidiaries. They should be reasonable and justifiable and be based on the fair market value of services provided or, when there is no market established for a particular service, on actual cost plus a reasonable profit. *The market value of similar services is the preferred basis of fee assessment.* When fees are based on cost plus a reasonable profit, there is less incentive for the efficient and effective use of resources, because a profit margin is built in regardless of the costs involved. In many situations, however, the cost method is the only method possible.

Any method of pricing services provided to bank subsidiaries that is based on anything other than value received is inappropriate. The fee mechanism should not be used to divert income from any bank subsidiary to meet the parent's financial needs if those needs are unrelated to the provision of services to that subsidiary. In addition, banks are prohibited from paying management fees* if it would cause the institution to become undercapitalized (see title I, section 131 of the FDIC Improvement Act of 1991 or section 38 of the FDIC Act).

Any fee for services to a banking subsidiary should be supported by evidence that the parent or other affiliate provided the service. Services provided by bank holding companies should serve the needs of the subsidiary bank; charges for services that appear to duplicate existing subsidiary-bank functions should be supported by a detailed explanation of the net benefit derived by the subsidiary bank and by an analysis of the reasonableness of the fee.

When it is impractical to allocate expenses on a direct-charge basis, bank holding companies frequently allocate overhead expenses to subsidiaries. Although this practice can be considered acceptable with regard to nonbanking subsidiaries, allocating all bank holding company expenses to bank subsidiaries is not permitted. The parent company should bear a portion of the costs connected with, for example, the holding company's investor/shareholder relations, regulatory reporting requirements, acquisitions, formations, applications, board of directors, and strategic planning. Bank holding companies are, however, expected to support their subsidiary banks, and expenses incurred to serve the needs of the subsidiary banks, such as expenses incurred in raising capital for subsidiary banks, can appropriately be allocated to those subsidiary banks that benefit from the services provided, in proportion to the benefit received from the service.

All fees for services rendered should be supported by written agreements that describe the service, the fees to be charged, and the method of allocating the fees among the subsidiaries. The absence of such contracts between the subsidiaries of the holding company is considered inappropriate and an unsafe and unsound banking practice. Supervisory action should be taken, in a manner consistent with the financial condition of the holding company and the subsidiary bank, to eliminate the improper practices. The practices should be criticized in the inspection report and actions taken to see that the situation is satisfactorily resolved. If the practices are having a serious impact on the bank, or if they might reasonably be expected to have a severe impact given the bank's financial condition, formal administrative action should be considered in order to require the holding company to terminate the practices and make restitution to the subsidiary bank.

* "Management fees" does not include fees for such services as electronic data processing or auditing.

A bank's prepayment of service fees to the parent company and payment of expenses incurred primarily in conjunction with holding company activities unconnected with the bank also are cause for supervisory concern. In general, prepayment for services is inappropriate unless the bank holding company can demonstrate that prepayment is standard industry practice for nonbanking companies acquiring the same service. Prepayment of sums for services that are not to be provided in the immediate future (for example, prepayment of an entire year's fees for services to be rendered throughout the year) can have an adverse impact on the bank and is therefore inappropriate. These practices should be addressed by requiring timely and reasonable payments for services and reimbursement to the banks for what are essentially holding company expenses. If bank expenses are incurred substantially in support of a holding company activity, the bank should be reimbursed for that portion of its cash outlay that benefits the holding company. Reimbursement is necessary to ensure that bank resources are not diverted to a holding company affiliate with little or no benefit to the bank.

Aside from reasonable and timely fees for services rendered, the most appropriate way, from a supervisory standpoint, for funds to be paid to the parent company is through dividends. This principle applies, in general, to bank payment of funds to service holding company debt, even when the debt was initially incurred to raise equity capital for the subsidiary bank. It is an inappropriate banking practice for the subsidiary bank to pay management fees for the purpose of servicing holding company debt. Funds for servicing holding company debt should, as a general rule, be upstreamed in the form of dividends.

2020.6.1 TRANSACTIONS SUBJECT TO FEDERAL RESERVE ACT SECTION 23B

Section 23B of the FRA applies to any covered transaction with an ''affiliate,'' as that term is defined in section 23A of the FRA. Section 23B also applies to a number of transactions that are not covered by section 23A, for example, transactions that involve the payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise, or transactions in which an affiliate acts as an agent or a broker or receives a fee for its services. Although transactions between sister banks and banks that are part of a chain banking organization are exempt from section 23B, section 23A requires that covered transactions between a bank and an affiliate be conducted at arm's length. See section 2020.1.2 for other transactions that are covered by section 23B and the requirements that pertain to all such transactions. For examples of transactions that could violate section 23B, see section 3700.10, dealing with an application to provide armored car services through a bank holding company's nonbank subsidiary.

2020.6.2 INSPECTION OBJECTIVES

1. To determine whether the holding company and its subsidiaries charge fees to bank subsidiaries based on value received and fair market value.
2. To determine whether the subsidiaries are actually receiving these services.
3. To determine that the timing of fee payments is appropriate.
4. To determine whether there is an agreement between the entities relating to specific services and fees charged.
5. To determine if any fees result in an unsafe or unsound condition in any subsidiary bank.

Once the management policy underlying the fee structure is clearly understood, it is important for the examiner to determine that practice is consistent with policy. For example, if management indicates that fees charged are based on the fair market value of services received but the fee structure is actually geared to the bank subsidiary's asset size, an inconsistency exists. Assuming either that all of the bank subsidiaries have access to the same or similar markets for the services being provided by the bank holding company or that cost is used consistently to determine pricing, the established pricing structure should be used for all subsidiaries. Deviations from established policy intended to channel a greater proportion of income from financially sound banks to financially weak ones should be noted.

When it has been established that the fee structure is reasonable and is consistently followed, a final question remains. Are the bank subsidiaries actually receiving the services for which they are charged? This may be difficult to ascertain in many cases, but serious efforts must be made.

It is important that the basic business principles of an arm's-length transaction be applied to all transactions between banks and their affiliates. This approach provides protection for all the interests involved. In addition, payment should be made within a reasonable time of the rendering of the services. It is inequitable for the bank subsidiary to pay fees far in advance in order to suit the parent's cash needs. A clearly understood agreement between the holding company and its bank subsidiaries detailing the duties and responsibilities of each party and the method to be used for fee assessment is also important to the servicing arrangement.

2020.6.3 INSPECTION PROCEDURES

1. Review and analyze the policy regarding management and other services provided to bank subsidiaries and the method of assessing fees.
2. Determine the basis for valuation.
3. Review the actual pricing structure as it is applied.
4. Verify the following:
   a. Fees are charged in accordance with pricing structure.
   b. Pricing structure is consistently applied for all bank subsidiaries.
   c. Bank subsidiaries are actually receiving services for which they are assessed. Determine whether fee payments have caused the institution to become undercapitalized.
   d. Payments are made in a timely manner.
5. Review examination reports on bank subsidiaries for comments on fee assessment.
6. Analyze the parent company's cash flow and income statements for intercompany fees.
7. Review recordkeeping.

A review of management's written or stated policy regarding services provided subsidiaries and fee assessment is a logical starting point for the analysis of this area. The policy should be discussed with the holding company's officers to ensure that the examiner has a clear understanding of the purpose and basic underlying philosophy. Any policy that calls for fee assessment based on standards other than fair market value or the cost of providing the services requires discussion with management and comment on page 1 of the report.

The determination of fair market value or cost of providing services is the responsibility of the holding company. The examiner should review the market or cost information used to justify the pricing of services and be satisfied that the data presented actually supports the fee structure. Request a copy of the pricing schedule as it is applied, and determine that it is actually based on the valuation of the services received and consistent with stated policy. Any variations from the basic structure among the bank subsidiaries would also require support from the market or cost data furnished.

Once the holding company's policy, valuation data, and pricing structure are analyzed, they should be verified. Check the service at the bank-subsidiary level. The verification process can be modified as deemed appropriate by the examiner.

Note the timing of payment for services. Fees for services should be billed and paid as they are received, just as they would be with an unaffiliated servicer. Prepayments are inappropriate in most cases.

Written service agreements should be in effect specifically detailing the types and extent of services being rendered and the method of pricing. Any significant exceptions found during the verification process merit follow-up and comments in the report.

Thus far, these inspection procedures for management and service fees have emphasized a review of management's stated intent and the actual fees charged on the individual bank-subsidiary level and have been somewhat oriented toward micro-level analysis. An overall view of the parent company's cash flow and income statements can also provide certain indicators of appropriateness of fees. The parent company should be servicing its debt and paying dividends from sources other than management fees and service fees collected from bank subsidiaries. If the ratio of management and service fees to parent-company salaries and other expenses significantly exceeds 100 percent, the holding company could be charging fees that are unrelated to the value of the service. This situation would call for further investigation.

2020.6.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Statement of practice and procedure in reference to unsound banking practices; diversion-of-bank-income practices (SR-79-533, March 19, 1979)			4–876	
Potential violations of section 23B of the Federal Reserve Act:				1993 FRB 352
1. Proposal by a bank holding company to provide armored car services to its banking subsidiary through a de novo nonbank subsidiary. The cost of the service would be more than the cost of armored car services currently received from an unaffiliated provider.				
2. Proposal whereby the bank holding company's de novo nonbanking subsidiary would pay a flat fee based on a percentage of its direct operating expenses to cover all the back-office services provided by the holding company's banking subsidiary.				

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The transfer of low-quality loans or other assets from one depository institution to another can be reason for supervisory concern. Such transfers may be made to avoid detection and classification during regulatory examinations, and may be accomplished through participations, purchases/sales, and asset swaps with other affiliated or nonaffiliated financial institutions. Section 23A of the Federal Reserve Act prohibits bank purchases of low-quality assets from an affiliate. Examiners should be alert to situations where an institution's intention appears to be the concealment of low quality assets for the purpose of avoiding examination scrutiny and possible classification.

During bank holding company inspections, examiners are requested to identify situations where low-quality assets have been transferred between the institution being examined and another depository institution. Low-quality loans broadly defined include loans which are classified or specially mentioned, or if subjected to review would most likely be classified or specially mentioned, past due loans, nonaccrual loans, loans on which the terms have been renegotiated because of a borrower's poor financial condition, and any other loans which the examiner feels are of questionable quality. Other assets of questionable quality would include depreciated or sub-investment grade securities and other real estate. The transfer of assets to avoid supervisory review is a highly improper and unsound banking practice and may be a violation of section 23A of the Federal Reserve Act that should be addressed through formal supervisory enforcement action, if necessary.

Any situations involving the transfer of low-quality or questionable assets should be brought to the attention of Reserve Bank supervisory personnel who, in turn, should notify the local office of the primary Federal regulator(s) of the other depository institution(s) involved in the transaction. For example, Reserve Banks should notify the primary Federal regulator of any depository institution to whom a State member bank or holding company is transferring or has transferred low quality loans. Reserve Banks should also notify the primary regulator of any depository institution from which a State member bank or holding company is acquiring or has acquired low-quality loans. This procedure applies to transfers involving savings and loan associations and savings banks, as well as commercial banking organizations.

If it is determined that a transfer of assets was undertaken for legitimate reasons, the examiner should make certain that the assets have been properly recorded on the books of the acquiring institution at fair market value. If the transfer was with the parent holding company or a nonbank affiliate, determine that the transaction is also properly recorded on the books of the affiliate. Refer to SR Letter 83–24 (FIS).

2020.7.1 INSPECTION OBJECTIVES

1. To ensure that loan transfers involving state member banks, bank holding companies, and nonbank affiliates are carefully evaluated to determine if they were carried out to avoid classification, and to determine the effect of the transfer on the condition of the institution and to ascertain whether the transfer was consistent with the requirements of Section 23A. Under section 23A of the Federal Reserve Act, an asset purchase is a "covered transaction." All "covered transactions" by a bank with a single affiliate and with all affiliates combined may not exceed 10 percent and 20 percent, respectively, of a bank's capital and surplus.
2. To ensure that the primary regulator of the other financial institution involved in the transfer is notified.

2020.7.2 INSPECTION PROCEDURES

1. Investigate any situations where assets were transferred prior to the date of examination to determine if any were transferred to avoid possible criticism during the examination.
2. Determine whether any of the loans transferred were nonperforming at the time of transfer, classified at the previous examination, or for any other reason were considered to be of questionable quality.
3. Review the policies and procedures to determine whether or not assets or participations purchased are given an independent, complete and adequate credit evaluation. If a bank is a holding company subsidiary or a member of a chain banking organization, review asset purchases or participations from affiliates or other known members of the chain to determine if the asset purchases are given an *arms-length* and *independent* credit evaluation by the purchasing bank.
4. Determine whether or not any purchases

of assets from an affiliate are in conformance with section 23A which generally prohibits purchases of low-quality assets from an affiliate and limits asset purchases and all other ‘‘covered transactions’’ by a bank from a single affiliate and all affiliates combined to 10 percent and 20 percent, respectively, of a bank’s capital and surplus.

5. Determine that any assets purchased are properly reflected at fair market value (while fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such assets and an appropriate risk premium). Determine that appropriate write-offs are taken on any assets sold at less than book value.

6. Determine that transactions involving transfers of low- quality assets to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and the holding company affiliate.

7. If poor quality assets were transferred to or from another financial institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary Federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:

- Name of originating and receiving institutions.
- Type of assets involved and type of transfer (i.e., participation, purchase/sale, swap).
- Date(s) of transfer.
- Total number and dollar amount of assets transferred.
- Status of the assets when transferred (e.g., nonperforming, classified, etc.)
- Any other information that would be helpful to the other regulator.

A bank holding company may be assessing trade-name or royalty fees on its subsidiary banks for their use of the holding company's name. Such holding companies may assert that the trade name-licensing agreements were created to achieve certain state tax benefits. They may also claim that such agreements were implemented to establish a basis for any damages that the company might seek if its trade name is used by an unauthorized third party. Further, consultants may try to market this practice to other bank holding companies.

Such payments are unlikely to bear any reasonable or justifiable relationship to any tangible asset or service provided by a holding company to a subsidiary bank. They are thus considered an improper diversion of bank income. If this practice is found during the course of an inspection, the practice should be stopped and examiners should direct the parent company to reimburse subsidiary banks for the fees paid. Depending on the materiality of the trade name or royalty fees, the Reserve Bank may also require restatement of regulatory filings. See SR-91-3.

Split-dollar life insurance is a type of life insurance in which the purchaser of the policy pays at least part of the insurance premiums and is entitled to only a portion of the cash surrender value, or death benefit, or both. See SR-93-37 and its attachments for further discussion of the Federal Reserve's position on such arrangements between bank holding companies and their subsidiary banks.

2020.9.1 SPLIT-DOLLAR LIFE INSURANCE POLICY ARRANGEMENTS

Certain split-dollar life insurance policy arrangements involving banks and their parent bank holding companies raise legal and safety-and-soundness concerns. These arrangements fall into two general categories: (1) those in which the subsidiary bank owns the policy, pays all or substantially all of the premiums and is reimbursed for the premium payments (if at all) at some time in the future (endorsement plans) and (2) those in which the parent holding company owns the policy, and pays the premium, but uses the insurance policy as collateral for loans from its subsidiary bank (collateral assignment plans).

2020.9.1.1 Split-Dollar Life Insurance Endorsement Plan

Under an endorsement plan, the subsidiary bank purchases a policy in which its parent bank holding company or an officer, director, or principal shareholder thereof is the primary beneficiary, rather than the bank or one of its officers or directors. In this instance, the subsidiary bank receives only a limited portion of the death benefit—usually an amount equal to its premium payments plus interest. The primary beneficiary—the holding company or one of its officers, directors, or principal shareholders—receives a majority of the insurance proceeds but pays little or nothing for the benefit. Many of the policies in this category are single-premium universal life policies, whereby the subsidiary bank pays one large lump sum premium payment for the policy. Generally, a subsidiary bank involved in an endorsement plan records the cash surrender value of the policy as an asset on its books; the bank holding company does not record anything at the parent-only level.

A variation of the endorsement plan is an arrangement in which the bank pays an annual premium towards the policy and the parent holding company reimburses the bank for a nominal amount of the annual premium payments. These amounts are substantially lower than the premium payments made by the subsidiary bank and therefore do not accurately reflect the economic benefit derived by the holding company as primary beneficiary of the insurance policy.

2020.9.1.2 Split-Dollar Life Insurance Collateral Assignment Plan

Under a collateral assignment plan, the parent bank holding company owns the policy and pays the entire premium. The subsidiary bank makes annual loans to the bank holding company in an amount equal to the annual increase in the cash surrender value of the policy (or, in some cases, in amounts equal to premiums paid) with the policy itself serving as collateral for the loan. The loans are repayable at either the termination of employment or the death of the insured employee, and will be paid using the death benefits available from the policy.

2020.9.2 COMPLIANCE WITH APPLICABLE LAWS

2020.9.2.1 Compliance with Sections 23A and 23B of the FRA

Both of the aforementioned types of split-dollar life insurance policy arrangements may be inappropriate if they are inconsistent with sections 23A or 23B of the Federal Reserve Act (FRA). Section 23A places quantitative restrictions and other requirements on certain transactions, including loans, between banks and their affiliates. The statute also requires that loans between banks and their affiliates be secured with collateral having a specified market value that depends on the type of collateral used to secure the loan. Under an endorsement plan, where the subsidiary bank pays all or substantially all of the insurance premiums, an unsecured extension of credit from the subsidiary bank to its parent holding company generally results because the subsidiary bank has paid the bank holding company's portion of the premium, and the bank will not be reimbursed fully for its payment until sometime in the future.

Under a collateral assignment plan, if the insurance policy held by the parent bank holding company serves as collateral to secure a loan from its subsidiary bank, the loan may be a violation of section 23A unless it meets the quantitative requirements of section 23A and the cash surrender value of the insurance policy used as security is equal to 130 percent of the amount of the loan. Thus, a bank loan to the parent bank holding company that equals the cash surrender value of the insurance policy that is serving as collateral would not be adequately secured under section 23A, unless additional collateral was provided.

Both categories of split-dollar life insurance policy arrangements may also lead to violations of section 23B of the Federal Reserve Act, which requires that certain transactions involving a bank and its affiliates be on terms and under circumstances substantially the same or at least as favorable to the bank as those prevailing at the time for comparable transactions with or involving nonaffiliated companies. Because the bank holding company is the beneficiary of the life insurance policy, it is a participant in a transaction between a bank and a third party; therefore, the split-dollar life insurance transaction must meet the standards of section 23B.[1] In order to conform to the statutory restrictions of section 23B, the return to the bank from ownership of the policy should be commensurate with the size and nature of its financial commitment. In most split-dollar insurance arrangements, the bank makes an investment in the policy not for the purpose of insuring itself against risk but for the purpose of obtaining insurance for its holding company. The only return that the bank will get from its participation in ownership of the policy is the return of its initial investment and possibly some interest. However, the insurance company deducts the cost of maintaining the insurance coverage from interest that would otherwise be credited to the equity in the policy. These costs include policy loads, surrender charges, and mortality costs. The holding company should fully reimburse the bank for all of these charges. Examiners should carefully evaluate these arrangements because, in many cases, the reimbursement the bank receives from the holding company is based on an implied value of the insurance coverage received by the holding company that is less than the assessments made to the policy equity.

In the process of evaluating split-dollar insurance arrangements, examiners should keep in mind the fact that the advances made by a bank to purchase the insurance are the equivalent of a loan to the holding company. Therefore, to comply with section 23B, the terms of the loan, such as its duration and interest rate, must be on market terms.

2020.9.2.2 Investment Authority Under the National Bank Act

Participation by bank holding companies and their state-chartered and national bank subsidiaries in split-dollar life insurance policy arrangements may also raise concerns whether the policies are permissible bank investments under section 24(7) of the National Bank Act. The Office of the Comptroller of the Currency's interpretation of this provision of the National Bank Act (OCC Banking Circular 249, May 9, 1991).[2] In addition, under section 24 to the Federal Deposit Insurance Act, a state-chartered bank generally may not, without the FDIC's permission, engage in any activity that is impermissible for a national bank.[3]

2020.9.3 SAFETY-AND-SOUNDNESS CONCERNS

The purchase of a split-dollar life insurance policy may also constitute an unsafe and unsound banking practice involving the diversion of bank income or assets. If a subsidiary bank pays the entire insurance premium but is not the beneficiary, it provides an economic benefit to its parent holding company or other beneficiary for which it is not being adequately reimbursed or compensated. In this instance, the bank loses the opportunity to use its assets productively. Generally, the bank pays the premium in return for the insurance company's payment of the entire proceeds. When the bank receives less than the entire proceeds, it has, in effect,

1. The Federal Deposit Insurance Corporation has taken the same position in a published interpretive letter, FDIC 92-40, dated June 18, 1992.

2. National banks may not purchase life insurance as an investment. See OCC Banking Circular 249, for the tests under which life insurance may be purchased and held for noninvestment purposes.

3. SR-92-97 (FIS) and SR-92-98 (FIS), dated December 16 and 21, 1992, respectively, describe the provisions of section 24 of the Federal Deposit Insurance Act.

paid a higher than market price for whatever limited benefit it may receive. This is also the case when the primary beneficiary of the policy is an officer, director, or principal shareholder of the parent holding company. Such an arrangement is not consistent with safe and sound banking practices because the subsidiary bank is conferring an economic benefit on an insider of the parent bank holding company without receiving adequate compensation.

2020.9.4 EXAMINER REVIEW OF SPLIT-DOLLAR LIFE INSURANCE

Examiners should be fully aware of the problems inherent in split-dollar life insurance policy arrangements between bank holding companies and their subsidiary banks. During the course of all bank examinations and bank holding company inspections, examiners should review corporate life insurance policy arrangements for compliance with applicable banking laws and safety-and-soundness standards.[4] If a split-dollar life insurance policy arrangement exists in either a bank holding company or a state member bank, it should be reviewed and modified if it does not comply fully with the law and principles of safe and sound banking. If a bank holding company or a state member bank fails to take appropriate action to bring its split-dollar life insurance policy arrangements into compliance, then the Reserve Bank should consider appropriate follow-up supervisory action (including a formal enforcement action) against the banking organization or its institution-affiliated parties, or both.

2020.9.5 INSPECTION OBJECTIVES

1. To determine if split-dollar life insurance arrangements between the parent holding company and its subsidiary banks are consistent with the provisions of sections 23A and 23B of the FRA.

2. To ascertain whether participation by bank holding companies and their national bank or state-chartered bank subsidiaries is consistent with section 24(7) of the National Bank Act and section 24 of the Federal Deposit Insurance Act.

3. To verify the cash surrender values of split-dollar life insurance policies and to establish whether those values have been impaired by loans to, liens by, or assignments to, third parties or by unauthorized borrowings or cancellations.

2020.9.6 INSPECTION PROCEDURES

1. Review corporate life insurance policy arrangements between the parent company and its subsidiary banks.

   a. Determine if there are split-dollar life insurance arrangements between any subsidiary bank and the parent company or officers or directors of the parent company.

   b. If any such insurance arrangement exists, establish if the plan is either an endorsement plan or a collateral assignment plan.

   c. Review arrangements involving a split-dollar life insurance policy purchased by the parent company.

      (1) Review external documentation evidencing the cash surrender value. If no documentation exists, ask the audit committee and its internal auditors—

         (a) to obtain external documentation verifying its value and

         (b) to verify that there are no outstanding loans, liens, or assignments against the insurance policies.

      (2) Establish whether the parent company's board of directors has established policies and implemented procedures for transactions between the insurance carrier and the parent company to prevent unauthorized borrowing or cancellation of any insurance policy that has a cash surrender value.

      (3) Determine whether the corporate life insurance policy arrangements are consistent with applicable safety-and-soundness standards.

      (4) Verify that the recorded value of the respective asset is equal to the unimpaired cash surrender value of the asset.

2. If an endorsement plan arrangement is purchased by a subsidiary bank, establish whether the bank holding company is the beneficiary. If the parent company is the beneficiary, such an arrangement may result in an unsecured exten-

4. Examiners conducting examinations of U.S. branches and agencies of foreign banks and Edge corporations should also be alerted to the problems associated with split-dollar life insurance arrangements because these institutions could purchase insurance for the benefit of a parent foreign bank or company, or one of the parent's officers or directors. In addition, section 7(h) of the International Banking Act of 1978 prohibits state-licensed branches or agencies from engaging in any activity that is impermissible for a federal branch unless the Board determines that such activity is consistent with "sound banking practice" and, in the case of an FDIC-insured branch, the FDIC determines that the activity poses no significant risk to the deposit insurance fund.

sion of credit when the subsidiary bank pays all or substantially all of the insurance premiums but is not reimbursed until some time in the future. Ascertain if the investment return to the bank from ownership of the policy is commensurate with the size and nature of its financial commitment.

3. If a collateral assignment plan (when the insurance policy held by the parent company serves as collateral to secure a loan from a subsidiary bank), ascertain whether the cash surrender value of the insurance policy is equal to 130 percent of the amount of the loan.

4. For both types of split-dollar life insurance:

a. Determine if the investment return from ownership of the policy is commensurate with the size and nature of the financial commitment, including all costs incurred for maintaining the insurance coverage.

b. Determine if the terms (duration and market interest rate) of the advances made to purchase the insurance are on market terms.

c. If the bank holding company is the beneficiary of a bank insurance policy and a bank is a participant in the purchase of the insurance from a third party, determine if the transaction was on terms and under circumstances that were substantially the same as or at least as favorable to the bank as those then prevailing for comparable transactions with or involving nonaffiliated companies.

2020.9.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Split-dollar life insurance:				
1. Endorsement plan: When a subsidiary bank has paid all the BHC's portion of the premium and the bank will not be reimbursed until some time in the future, a loan results that must be secured.	371c, FRA section 23A			
2. Collateral assignment plan securing a loan: Cash surrender value must be 130 percent of the loan.	371c, FRA section 23A			
3. Both plans:				
a. Transactions must be on terms and under circumstances substantially the same as those prevailing for third-party transactions.	371c, FRA section 23B			

2020.9.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
b. When the BHC is the beneficiary, the bank's investment return from the split-dollar life insurance policy should be commensurate with the size and nature of the financial commitment.	371c-1, FRA section 23B			
Split-dollar life insurance premiums paid by a bank on behalf of an executive officer of the bank are not deemed an extension of credit for purposes of Regulation O, if the officer reported the premiums as taxable compensation to the IRS.			Regulation O staff opinion 3-1081.3	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The history of bank holding company legislation reflects a principle that banking and commerce should be separated in order to prevent abuses in the distribution of credit. The 1956 Act generally required companies to divest their nonbank activities and shares within two years. In the 1970 Amendments, the same requirement applied to companies formed in the future. However, one-bank holding companies in existence at the time of these amendments were given a "grace period" to comply with divestiture requirements of the legislation. Those companies whose bank and nonbank interests had been combined on or before June 30, 1968, were permitted to continue the existing combination for an indefinite period (indefinite or permanent grandfather privileges). But those BHCs which existed at the time of the 1970 Amendments, but whose bank was acquired or whose nonbank activity was initiated after June 30, 1968, were permitted to continue their nonbank activities for only 10 years until December 31, 1980. An exception to the divestiture deadline existed with respect to certain real estate holdings.

Because of Congressional concern about the effectiveness of a divestiture, Congress included section 2(g) in the Act, and particularly subsection 2(g)(3) which treats the transfer of control. In this section, care is taken to eliminate possible control relationships between the company and its divested assets.

Although indefinitely grandfathered companies may continue to engage in nonbanking activities, these grandfather privileges are subject to review by the Federal Reserve Board at the time when a company's banking assets exceed $60 million.[1]

2030.0.1 INDEFINITE GRANDFATHER PRIVILEGES

Under the provisions of section 4(a)(2) of the Act, as amended in 1970, relating to grandfather privileges for certain nonbanking activities of bank holding companies, the Reserve Banks have been delegated the authority to determine that termination of grandfathered activities of a particular bank holding company is not warranted; provided, the Reserve Bank is satisfied that all of the following conditions are met:

1. The company or its successor is "a company covered in 1970;"
2. The nonbanking activities for which indefinite grandfather privileges are being sought do not present any significant unsettled policy issues; and
3. The bank holding company was lawfully engaged in such activities as of June 30, 1968 and has been engaged in such activities continuously thereafter.

A company covered in 1970 is defined in section 2(b) of the Act as "a company which becomes a bank holding company as a result of the enactment of the Bank Holding Company Act Amendments of 1970 and which would have been a bank holding company on June 30, 1968, if those amendments had been enacted on that date." The Board has also determined that the company must have owned at least 25 percent of the voting shares of the same subsidiary bank on June 30, 1968, and December 31, 1970, in order to qualify as a company covered in 1970. If a company was not actively engaged in a nonbank activity prior to June 30, 1968, either directly, or indirectly through a subsidiary, it may still qualify for indefinite grandfather privileges if the company had entered into a binding contract prior to June 30, 1968. The binding contract must be a written document which specifies that the company (or its subsidiary) or persons representing the company will purchase another company which is already engaged in the activity.

Within two years after the subsidiary bank of an indefinitely grandfathered company attains banking assets in excess of $60 million, the status of the company's grandfather privileges is subject to review to determine whether the rights should remain in effect or be terminated. The Board or Reserve Bank may also review any company's grandfather privileges and terminate them if it determines that such action is necessary to prevent (1) undue concentration of resources, (2) decreased or unfair competition, (3) conflicts of interests, or (4) unsound banking practices. Moreover, when a company applies for approval of an acquisition, it may expect the Board or Reserve Bank to review the legitimacy of its grandfather privileges.

1. Effective October 20, 1981 the Board amended its Rules Regarding Delegation of Authority to delegate to the Reserve Banks authority to make these determinations regarding indefinite grandfather privileges.

2030.0.2 ACTIVITIES AND SECURITIES OF NEW BANK HOLDING COMPANIES

A company that becomes a bank holding company may, for a period of two years, engage in nonbanking activities and control voting securities or assets of a nonbank subsidiary, if the bank holding company engaged in such activities or controlled such voting securities or assets on the date it became a bank holding company. The Board can grant requests for up to three one-year extensions of the two-year period. This is in accordance with a December 1983 revision to Regulation Y (12 C.F.R. 225.22(e)). The regulatory provision implements Section 4(a)(2) of the BHC Act.

2030.0.3 LIMITATIONS ON EXPANSION OF GRANDFATHER RIGHTS FOR INSURANCE AGENCY NONBANKING ACTIVITIES OF BANK HOLDING COMPANIES

Refer to Manual section 3170.0.3.4.1.

2030.0.4 SUCCESSOR RIGHTS

When a bank holding company transfers its bank shares to another company in a manner that produces no substantial change in the control of the bank, the transferee qualifies under section 2(e) of the Act as a ''successor.'' The ''successor'' provision prevents a bank holding company from transferring its bank to some other organization. A successor is considered a bank holding company from the date the transferor became a bank holding company. Thus, it may hold the same grandfather privileges as its predecessor. By the same token, it becomes subject to any conditions or restrictions, such as divestiture requirements, imposed by the System upon its predecessor. For example, an irrevocable declaration filed by the predecessor would be binding upon the successor.

2030.0.5 EXPANSION OF GRANDFATHER ACTIVITIES

Grandfather privileges apply to activities, not to companies. As a general rule, these activities are permitted to be expanded through internal growth; however, there are a few exceptions. See Appendix 1 in this section.

In Appendix 1 it is important to distinguish between a purchase in the ordinary course of business and a purchase, in whole or in part, of a going concern. Each of the following conditions must be satisfied in order for the transaction to be in the ''ordinary course of business,'' which is permissible: (1) less than a substantial amount of the assets of the company to be acquired must be involved; (2) the operations of the purchased company must not be terminated or substantially discontinued; (3) the assets acquired must not be significant in relation to the size of the same line of nonbank activity already in the holding company (an acquisition is deemed significant if the book value of the acquired nonbank assets exceeds 50 percent of the book value of the nonbank assets of the holding company or nonbank subsidiary comprising the same line of activity); (4) if the transaction involves the acquisition of assets for resale, the sale must be a nominal business activity of the acquiring company; and (5) the major purpose of the transaction must not be to hire essentially all of the seller's principal employees who are expert, skilled and experienced in the business of the company being acquired. If any of these five conditions is not satisfied, the transaction may be considered to be an acquisition of a going concern, which is not permissible without prior approval. Refer to 12 C.F.R. 225.132.

2030.0.6 DIVESTITURES *(also see Manual section 2090.6)*

The act specifies the time in which a company must divest of any impermissible activity. Any company becoming a bank holding company subsequent to the 1970 Amendments has two years in which to divest its impermissible activity. The Act allowed a temporarily grandfathered company ten years from December 31, 1970, to divest of its impermissible activities, except certain real estate holdings discussed earlier; and allows indefinitely grandfathered companies ten years from the date on which grandfather privileges are terminated by the Board or Reserve Bank, should they be terminated for good cause.

As mentioned earlier, reviews of a company's grandfather privileges may be precipitated by such circumstances as: (1) a subsidiary bank of an indefinitely grandfathered company attaining assets in excess of $60 million (reviewed within two years); (2) a company seeking approval to engage in another activity or acquire another bank; (3) a company which violates the Act; or (4) a company operating in a manner which results in an undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices.

When a company has filed an application requiring the Board's or Reserve Bank's approval, the Board or Reserve Bank may approve the application subject to the condition that the company divest of certain grandfathered shares or assets within a specified time period. The specified time period generally will be shorter than the aforementioned time periods stipulated in the Act.

The plan of divestiture should have provided for the removal of any control relationship between the company and its divested activities. These control requirements, as outlined in section 2(g) of the Act, include one or more of the following: (1) no interlocking directorates; (2) ownership of less than 25 percent of the voting shares by the BHC and related parties; (3) no interlocking management positions in policymaking functions; (4) no indebtedness between the transferor and the transferee; (5) no agreement or understanding which restricts the voting privileges of shares. Further discussion of these and other control requirements and issues is found in Manual sections 2090.1 and 2090.6.

2030.0.7 INSPECTION OBJECTIVES

1. To determine when the company acquired its subsidiary bank.
2. To determine when the company commenced its nonbanking activities and whether these activities were conducted continuously thereafter.
3. To determine if the banking assets of a bank controlled by a holding company with indefinite grandfather privileges have reached $60 million.
4. To determine if a change of ownership or control of the company has taken place, and whether the transferee qualifies as a "successor."
5. To determine if expansions of grandfathered activities occurred in accordance with the Act.

2030.0.8 INSPECTION PROCEDURES

1. If necessary, examine the subsidiary bank's stock certificate book to determine when the company acquired 25 percent or more of the bank.
2. Review the minute books and historical financial records of the company and its subsidiaries for evidence of the date of commencement of any nonbank activity and its continuation thereafter. In particular, the financial records should reflect the activity's impact as either an asset and/or an income item. From these records, also determine whether there has been expansion of the activity and whether such expansion complies with the Act.
3. If necessary, review the latest quarterly Call Report of Condition for the subsidiary bank to determine whether total assets exceeded $60 million. If appropriate, advise management that its grandfather status is subject to review.
4. If necessary, examine the stock certificate records and minutes of the bank or BHC to determine if the bank's shares have been transferred from one bank holding company to another in such a manner that the transferee qualifies as a successor.
5. Upon review of the aforementioned records, discuss the status of the company's grandfather privileges with the Reserve Bank's management, if necessary.
6. If divestment is required, encourage its execution as soon as possible during the divestment period. Request a divestment plan which specifies the manner by which divestment will be accomplished, the specific steps necessary to effect the divestment, and the time schedule for taking such steps. Advise management that failure to divest within the prescribed time period will be viewed as a violation of the Act.

2030.0.9 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Divestment of activities which are temporarily grandfathered			S-2346 February 15, 1977	
Escrow agreements used in divestiture				1976 FRB 151
Companies with temporarily grandfathered activities encouraged to submit plans by June 30, 1978				1977 FRB 962
Divestment policies	4(a)(2)			1977 FRB 263
Denial of grandfather rights for activities which were shifted from subsidiary bank to nonbank subsidiary				Whitney Holding Corporation, New Orleans, Louisiana; April 27, 1973
Denied continued ownership of a savings and loan association, despite permanent grandfather rights				D.H. Baldwin Company, Cincinnati, Ohio; February 22, 1977
Discussion of indefinite grandfather rights acquired through the indirect power to exercise a controlling influence				Patagonia Corporation, Tucson, Arizona; February 24, 1977
Denial of grandfather rights on additional stock acquired after June 30, 1968, for lack of a controlling influence over the subsidiary as of June 30, 1968				Patagonia Corporation, Tucson, Arizona; July 6, 1973
Successor rights				Republic of Texas Corporation, Dallas, Texas; October 25, 1973

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Interprets "Company covered in 1970" and "Successor"				American Security Corporation, Washington, D.C.; July 21, 1976
Review of grandfather rights as a result of subsidiary bank reaching $60 million in total assets				Colorado Funding Company, Denver, Colorado; September 9, 1977
Review of grandfather rights as a result of subsidiary bank reaching $60 million in total assets—charitable trust involved				General Education Fund, Inc., Burlington, Vermont; September 13, 1977
Companies going out of business are not going concerns				Senate Report 90–1084, page 5524
Failing companies are not going concerns				1974 FRB 725
Ownership of less than 25 percent of a nonbanking company represents an investment rather than a subsidiary				1973 FRB 539
Divestitures		225.138 and 225.140		
Extension of divestiture deadline for real estate interests	Monetary Control Act of 1980 Section 701(b)			
Delegation of authority to Reserve Banks re: Indefinite Grandfathered activities		265.2(f)(42)		1981 FRB 856 and 860

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Activities and securities of new bank holding companies		225.22(e)		
Denial of a BHC acquisition—“successor”				1984 FRB 667
Acquisition of assets		225.132		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

2030.0.10 APPENDIX 1—EXPANSION OF GRANDFATHERED ACTIVITIES

Permissible Type of Expansion	*Without Approval*	*Requires Approval*
FOR COMPANIES WITH AN INDEFINITELY GRANDFATHERED NONBANK ACTIVITY		
1. Opening of additional offices of existing subsidiary	X	
2. Acquisition of assets in the “ordinary course of business” as defined	X	
3. Acquisition of a going concern:		
a. Additional shares of the grandfathered nonbanking subsidiary	X	
b. Additional shares of a nonbanking company which is regarded as an investment (generally companies in which the holding company has an interest of between 5 and 25 percent)		X
c. Initial acquisition of shares of any other company engaging in the activity		X

Commitments to the Federal Reserve

Section 2040.0

Commitments to the Board arise most often through the application process. Many commitments are included within the text of accompanying Board orders or letters transmitted to the applicants. Commitments can also arise through the supervisory process. Commitments should be specific and furnished in written form.

The most common type involves a commitment to inject capital (either equity or debt capital) into the company or subsidiary to be acquired or possibly into other subsidiaries of the bank holding company. The required injections may be for a specific dollar amount or for an unspecified amount necessary to achieve a predetermined capital relationship. Determining compliance with such commitments is generally not difficult since an agreed upon quantifiable result must be achieved.

Types of commitments made to the Board in the past include: divestiture of nonpermissible stock holdings or activities; introduction of new services; and reduction or elimination of dividends or management fees from subsidiaries.

Several of the above forms of commitments are rather difficult to monitor due to their inexact nature. The examiner should determine in such cases whether good faith compliance efforts have been made. Where an order approving an application imposes specific conditions, however, compliance is of the utmost importance since a conditional order is based on the theory that such conditions were necessary to eliminate or outweigh adverse factors. Willful noncompliance in these cases might necessitate the use of cease-and-desist powers to prevent evasion of the purposes of the Act. Pursuant to the Board's request, each Reserve Bank reports semi-annually on the status of all outstanding commitments made by holding companies in its District.

2040.0.1 INSPECTION OBJECTIVES

1. To determine that the bank holding company is taking the necessary steps to fulfill any outstanding commitments as scheduled.
2. To determine whether additional commitments or conditions should be imposed to achieve complete compliance.
3. To determine whether a request for an extension of time to fulfill any outstanding commitment is warranted.

2040.0.2 INSPECTION PROCEDURES

1. Review semi-annual commitment reports to the Board for commitments fulfilled since the last inspection. Determine whether such commitments were completed as required.
2. Review with management any actions taken to comply with outstanding commitments or plans to effect fulfillment.
3. If warranted, initiate action to consider an extension for compliance on outstanding commitments.

2050.0.1 BHC OFFICIAL AND RELATED INTEREST TRANSACTIONS BETWEEN THE PARENT COMPANY OR ITS NONBANK SUBSIDIARIES

Business transactions between a parent bank holding company or its nonbank subsidiary and a BHC official or a BHC official's related interests require close supervisory review. ''Bank holding company official'' is defined as any director, executive officer, or principal shareholder of the parent company or any of its subsidiaries, excluding the subsidiary bank's nonbank subsidiaries.

Most of these transactions are soundly structured and have a legitimate business purpose that result in equitable treatment for all parties. However, examiners should pay close attention to all extensions of credit by a BHC or its nonbank subsidiary to a BHC official or related interest to ensure that the terms of the credit, particularly interest-rate and collateral terms, are not preferential, and that the credit does not involve more than a normal risk of repayment.

An extension of credit by a BHC or nonbank subsidiary may be considered abusive or self-serving if its terms are unfavorable to the lender, or if the credit would not have been extended on the same terms absent the official relationship; that is, it would be improbable that each party to the credit would have entered into the credit transaction under the same terms if the relationship did not exist. When a transaction appears questionable, a complete inquiry into the facts and circumstances should be undertaken so that a legal determination can be obtained.

2050.0.2 TRANSACTIONS INVOLVING OTHER PROPERTY OR SERVICES

Other transactions involving BHC officials, their related interests, and the BHC and nonbank subsidiary that should be reviewed by the examiner include the—

1. purchase of assets or services from the BHC or nonbank subsidiary, particularly if at a discount or on preferential terms;
2. sale of assets or services to the BHC or nonbank subsidiary, particularly if at a premium;
3. lease of property to or from the BHC or nonbank subsidiary; and
4. use of BHC or nonbank subsidiary property or personnel by a BHC official or related interest.

As with loans and other extensions of credit to BHC officials on preferential terms, abusive or self-serving insider transactions involving other property or services deprive the BHC or nonbank subsidiary of higher returns or gains that may have been achieved had the same transaction been at a fair market price. A fair market price would be that price charged or received from an unaffiliated party.

A fair market price is often difficult to determine because the assets or services involved may be unique to a given situation and individuals. In general, the fair market price of even unique assets or services can be approximated by the cost of the assets or services to the party selling or furnishing them, if appropriate. The value of services or properties provided by a BHC or nonbank subsidiary should be established and justified either by policy or on a case-by-case basis, and appropriate documentation should be available to the examiner.

Services provided by a BHC official or a related interest to a BHC or nonbank subsidiary, while not unusual, may be most difficult to value. In part because of the problem of valuation, this type of transaction is among the most susceptible to abuse. The cost of providing services is frequently derived by placing value on the time of the individuals providing the services. When services are provided by a BHC official who normally places a very high billing value on time provided, the benefits to the BHC must be assessed in order to form a basis for determining a fair price. The BHC official may be a highly regarded professional whose time and services have great value to the organization. However, when the BHC requires routine clerical services, officials should not charge the BHC a professional-level rate for such services. Under these or similar circumstances, the BHC would be considered imprudent in paying such rates and could be subject to critical comment.

2050.0.3 REGULATION O

For ease of reference, certain Regulation O definitions and limitations, as revised by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), are presented here, some in abbreviated form. A thorough review of the entire regulation (found at FRRS 3–960), and the Board's press releases pertaining to Regulation O, is necessary for a complete understanding of the regulation. (Note that section 108 of the Financial Institutions Regulatory Act of 1978 amended section 18(j) of the Federal Deposit Insurance Act to make section 22(h) of the Federal Reserve Act applicable to nonmember insured banks.)

Purpose of Regulation O. Regulation O governs any extension of credit by a member bank and its subsidiaries (based on amendments contained in FDICIA, Regulation O also applies to nonmember insured depository institutions) to an executive officer, director, or principal shareholder of (1) the member bank, (2) a bank holding company of which the member bank is a subsidiary, and (3) any other subsidiary of that bank holding company. It also applies to any extension of credit by a member bank to (1) a company controlled by such a person and (2) a political or campaign committee that benefits or is controlled by such a person.

Supervision of BHCs and their nonbank subsidiaries. Regulation O deals exclusively with extensions of credit by banks and their subsidiaries, not extensions of credit by BHCs and their nonbank subsidiaries. However, because the regulations curtail or eliminate abusive transactions, they can be used as a guide or model in providing standards for the supervisory review of extensions of credit by BHCs and nonbank subsidiaries. Although a direct extension of credit by a BHC could not be determined to be a *violation* of Regulation O, if the credit fails to meet the requirements that Regulation O establishes for banks, it may be possible to conclude that the BHC is engaging in either an unsafe or unsound practice that exposes the entire banking organization to undue risk and exposure to loss. Regulation O limits credit extensions by a bank to officials of that bank and their related interests; therefore, examiners should be especially alert to credit extensions from BHCs and nonbank subsidiaries. If credit extensions appear to circumvent the intent of Regulation O, they should be identified and discussed with management, and noted in the inspection report for follow-up review and possible formal corrective action by regulatory authorities.

2050.0.3.1 FDICIA and BHC Inspection Guidance for Regulation O

On April 22, 1992, the Board adopted amendments to Regulation O, effective May 18, 1992, to implement the changes required by section 306 of FDICIA. Section 306 amended section 22(h) of the Federal Reserve Act and replaced the language of section 22(h) with the provisions of the Board's Regulation O. Section 306 also made several substantive modifications to section 22(h) that required revisions to Regulation O. These changes are outlined in the Board's press release and *Federal Register* notice of May 28, 1992 (57 FR 22417).

The following are some of the more significant changes that were made effective May 18, 1992:[1]

1. *Aggregate lending limit (section 215.4(d)).* The aggregate limit on the total amount that a bank can lend to its insiders and their related interests as a class was changed. In general, this amount is equal to the bank's unimpaired capital and unimpaired surplus. The Board also decided as a one-year interim measure to permit banks with deposits under $100 million to adopt a higher limit, not to exceed 200 percent of the bank's unimpaired capital and unimpaired surplus. (This interim period was extended twice by the Board, extending the higher limit through February 18, 1994, when the higher limit became permanent.)

2. *Lending limits for directors and related interests (section 215.4(c)).* Loans to directors (and their related interests) are subject to the same lending limit that is applicable to executive officers and principal shareholders (and their related interests). There had previously been no limit on the amount that directors and their related interests could borrow from banks.

3. *Credit standards (section 215.4(a)).* When lending to an insider[2] a bank must follow credit underwriting procedures that are as stringent as those applicable to comparable transactions by the bank with persons outside the bank.

4. *Definition of ''principal shareholder'' (section 215.2(m)(1)).* The definition of ''principal shareholder'' was tightened for banks located in small communities. The previously existing 10 percent limitation was made applica-

1. The Regulation O cites are to the February 18, 1994, amendment.

2. Effective with the amendment of February 18, 1994, the term ''insider'' refers to any insider of the bank or insider of its affiliates.

ble to all banks, regardless of the size of the communities in which they were located.[3]

5. *Definition of "member bank" (section 215.2(j)).* The term "member bank" was redefined to include any subsidiary of the member bank. This revision clarified that an extension of credit from a subsidiary of a member bank is subject to the same insider restrictions as an extension of credit from a member bank itself.

6. *Coverage of all companies that own banks (section 215.2(b)).* All companies that own banks became subject to Regulation O, regardless of whether they are technically bank holding companies.

7. *Prohibition on knowingly receiving unauthorized extensions of credit (section 215.6).* Insiders are prohibited from knowingly receiving (or permitting their related interests to receive) any extension of credit not authorized by section 22(h) of the Federal Reserve Act.

8. *Reporting requirement for certain credit (section 215.12).* Executive officers and directors of member banks that do not have publicly traded stock are required to report annually to their institutions the outstanding amount of any credit secured by shares of the insider's institution.

In a February 18, 1994, press release, the Federal Reserve Board announced its approval of a final rule that further amended several provisions of Regulation O, effective on that date. Some of the provisions carried out or further refined provisions of FDICIA. The amendments were designed to increase the ability of banks to make extensions of credit that pose minimal risk of loss, to eliminate recordkeeping requirements that impose a paperwork burden, and to remove certain transactions from the regulation's coverage consistent with bank safety and soundness. The amendments were expected to increase the availability of credit, particularly in communities served by small banks. The following is a discussion of some of the rule's primary provisions.

1. *Aggregate lending limit—exception for small, adequately capitalized banks (section 215.4(d)).* This revision of Regulation O made permanent an interim rule increasing the aggregate lending limit for small, adequately capitalized banks from 100 percent of the bank's unimpaired capital surplus to 200 percent, provided the bank satisfies three conditional criteria.

2. *Exceptions to the general limits on lending (section 215.4(d)(3)).* The Board adopted certain exceptions to the general restrictions on lending to insiders. The exceptions apply to loans fully secured by—

a. obligations of the United States or other obligations fully guaranteed as to principal and interest by the United States;

b. commitments or guarantees of a department or agency of the United States; or

c. a segregated deposit account with the lending bank.

An exception is also made for loans arising from the discount of installment consumer paper by an insider with full or partial recourse endorsement or guarantee by the insider, if the maker of the paper is not an insider and the loan was made relying primarily on the maker and this is properly documented. Such loans continue to be subject to the prohibitions against preferential lending.

3. *Including closing costs in the refinancing of home mortgage loans (section 215.5(c)(2)).* Section 22(g) of the Federal Reserve Act allows a bank to make a loan to its executive officer, without restrictions on the amount, if the loan is secured by a first lien on a dwelling that is owned and used by the executive officer as a residence after the loan is made. The Board's amendment includes the refinancing of home mortgage loans in this category only if the proceeds are used to pay off the previous home mortgage loan or for the other purposes listed in this section. The regulation states that closing costs can be included as part of the exempt portion of a home mortgage refinancing.

4. *Prior approval of home mortgage loans (section 215.5(c)).* This section was revised to mirror section 22(g) of the Federal Reserve Act. It provides that a bank's board of directors must specifically approve in advance a home mortgage loan to an executive officer. This requirement is in addition to the general requirements for insiders. Section 22(g) was recently amended to eliminate this prior-approval requirement, and the requirement in Regulation O is no longer in effect.

3. The Board amended the definition of "principal shareholder of a member bank," effective December 17, 1992, so that it does not include a company of which a member bank is a subsidiary. This amendment excludes from Regulation O loans to a company that owns, controls, or exercises a controlling influence over a member bank, as those relationships are defined in section 2(d) of the Bank Holding Company Act, as well as the related interests of such a parent bank holding company. The definition of "principal shareholder" for purposes of reporting obligations under section 215.11 and subpart B of Regulation O was not changed as a result of the Housing and Community Development Act of 1992 because those portions of Regulation O implement provisions of law in addition to section 22(h) of the Federal Reserve Act.

5. *Alternative recordkeeping procedures (section 215.8).* Banks are permitted to follow alternative recordkeeping procedures on loans to insiders of affiliates. The amendment allows a bank to decide on its own how to gather information on related interests, so long as its method is effective. For example, a nonbank credit card bank or other bank that does not make commercial loans could decide not to keep records on related interests. For banks that make commercial loans, one of two acceptable methods is required, unless a bank can demonstrate that another method is equally effective: (a) the ''survey'' method or (b) the ''borrower inquiry'' method. Every bank, regardless of the recordkeeping method it selects, must conduct an annual survey to identify *its own insiders*, but not those of its holding company affiliates. Every bank is expected to check this short list before extending credit, even if it is using the borrower-inquiry method of recordkeeping for affiliates in lieu of the survey method.

6. *Tangible-economic-benefit rule (section 215.3(f)).* This rule was similar to a provision in section 23A of the Federal Reserve Act and was adopted at a time when the Board was required by section 22(h) of the Federal Reserve Act to use the definition of ''extension of credit'' found in section 23A. However, the definition of extension of credit in section 22(h) is no longer tied to section 23A. The Board has therefore revised the tangible-economic-benefit rule to clarify that it does not reach certain transactions that may benefit an insider. The Board explicitly provided that the rule does not apply to an arm's-length extension of credit by a bank to a third party where the proceeds of the credit are used to finance the bona fide acquisition of property, goods, or services from an insider or an insider's related interest.

2050.0.3.2 Definitions in Regulation O (abbreviated listing)

NOTE: Regulation O definitions, prohibitions, and exceptions and exemptions are particularly detailed and complex. Therefore, inspection staff should consult with Reserve Bank or Board supervisory or legal staff before discussing with management or presenting in an inspection report any BHC inspection findings that rely upon Regulation O.

(a) ''Affiliate'' means any company of which a member bank is a subsidiary or any other subsidiary of that company.

(b) ''Company'' means any corporation, partnership, trust (business or otherwise), association, joint venture, pool syndicate, sole proprietorship, unincorporated organization, or any other form of business entity. The term, however, does not include (1) an insured bank (as defined in 12 U.S.C. 1813) or (2) a corporation the majority of the shares of which are owned by the United States or by any state.

(c)(1) ''Control of a company or bank'' means that a person directly or indirectly, or acting through or in concert with one or more persons (i) owns, controls, or has the power to vote 25 percent or more of any class of voting securities of the company or bank; (ii) controls in any manner the election of a majority of the directors of the company or bank; or (iii) has the power to exercise a controlling influence over the management or policies of the company or bank. (Note: If a company does not have voting securities (i.e., a partnership), review the degree of interest in the company to determine control.)

(2) A person is presumed to have control, including the power to exercise a controlling influence over the management or policies, of a company or bank if (i) the person is an executive officer or director of the company or bank and directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank; or (ii) the person directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank, and no other person owns, controls, or has the power to vote a greater percentage of that class of voting securities.

(3) An individual is not considered to have control, including the power to exercise a controlling influence over the management or policies, of a company or bank solely by virtue of the individual's position as an officer or director of the company or bank.

(d) ''Director'' of a member bank or company means any director of a member bank or company, whether or not receiving compensation.[3a] An advisory director is not con-

3a. Extensions of credit to a director of an affiliate of a bank are not subject to the general prohibitions (section 215.4), the prohibitions on knowingly receiving unauthorized extensions of credit (section 215.6), and the alternative recordkeeping procedures (section 215.8) if—

(1) the director of the affiliate is excluded, by resolution of the board of directors or by the bylaws of the bank, from participation in major policymaking functions of the bank,

sidered a director if the advisory director (1) is not elected by the shareholders of the bank or company, (2) is not authorized to vote on matters before the board of directors, and (3) provides solely general policy advice to the board of directors.

(e)(1) ''Executive officer'' of a company or bank means a person who participates or has authority to participate (other than in the capacity of a director) in major policymaking functions of the company or bank, whether or not the officer has an official title; the title designates the officer an assistant; or the officer is serving without salary or other compensation.[4] The chairman of the board, the president, every vice president, the cashier, the secretary, and the treasurer of a company or bank are considered executive officers, unless the officer is excluded, by resolution of the board of directors or by the bylaws of the bank or company, from participation (other than in the capacity of a director) in major policymaking functions of the bank or company, and the officer does not actually participate therein.

(2) Extensions of credit to an executive officer of an affiliate of a member bank (other than a company that controls the bank) are not subject to sections 215.4, 215.6, and 215.8 of Regulation O if—

(i) the executive officer of the affiliate is excluded, by resolution of the board of directors or by the bylaws of the bank, from participation in major policymaking functions of the bank, and the executive officer does not actually participate in those functions;

(ii) the affiliate does not control the bank; and

(iii) as determined annually, the assets of the affiliate do not constitute more than 10 percent of the consolidated assets of the company that controls the bank and is not controlled by any other company, and the executive officer of the affiliate is not otherwise subject to sections 215.4, 215.6, and 215.8 of Regulation O.

If the executive officer of the affiliate is excluded, by resolution of the board of directors or by the bylaws of the bank, from participation in major policymaking functions of the bank, a resolution of the board of directors or a corporate bylaw may (i) include the executive officer (by name or by title) in a list of persons excluded from participation in such functions; or (ii) not include the executive officer in a list of persons authorized (by name or by title) to participate in such functions.

(f) ''Immediate family'' means the spouse of an individual, the individual's minor children, and any of the individual's children (including adults) residing in the individual's home.

(g) ''Insider'' means an executive officer, director, principal shareholder, and any related interest of such person.

(h) The ''lending limit'' for a member bank is an amount equal to the limit on loans to a single borrower established by section 5200 of the Revised Statutes,[5] 12 U.S.C. 84. This amount is 15 percent of the bank's unimpaired capital and unimpaired surplus in the case of loans that are not fully secured, and an additional 10 percent of the bank's unimpaired capital and unimpaired surplus in the case of loans that are fully secured by readily marketable collateral having a market value, as determined by reliable and continuously available price quotations, at least equal to the amount of the loan. The lending limit also includes any higher amounts that are permitted by section 5200 of the Revised Statutes for the types of obligations listed therein as exceptions to the limit.

A member bank's *unimpaired capital* and *unimpaired surplus* equals the (1) member bank's tier 1 and tier 2 capital included in the

and the director does not actually participate in those functions;

(2) the affiliate does not control the bank; and

(3) as determined annually, the assets of the affiliate do not constitute more than 10 percent of the consolidated assets of the company that controls the bank and is not controlled by any other company, and the director of the affiliate is not otherwise subject to sections 215.4, 215.6, and 215.8 of Regulation O.

If the director of the affiliate is excluded, by resolution of the board of directors or by the bylaws of the bank, from participation in major policymaking functions of the bank, a resolution of the board of directors or a corporate bylaw may (1) include the director (by name or by title) in a list of persons excluded from participation in such functions or (2) not include the director in a list of persons authorized (by name or by title) to participate in such functions.

4. The term ''executive officer'' is not intended to include persons who may have official titles and may exercise a certain measure of discretion in the performance of their duties, including discretion in the making of loans, but who do not participate in determining major policies of the bank or company and whose decisions are limited by policy standards fixed by the senior management of the bank or company. For example, the term does not include a manager or assistant manager of a branch of a bank unless that individual participates, or is authorized to participate, in major policymaking functions of the bank or company.

5. Where state law establishes a lending limit for a state member bank that is lower than the amount permitted in section 5200 of the Revised Statutes, the lending limit established by the applicable state laws shall be the lending limit for the state member bank.

bank's risk-based capital, under the capital guidelines of the appropriate federal banking agency, and (2) balance of the member bank's allowance for loan and lease losses that was not included in the bank's tier 2 capital. This computation is based on the bank's risk-based capital under the capital guidelines of the appropriate federal banking agency, based on the bank's most recent consolidated report of condition filed under 12 U.S.C. 1817(a)(3).

(i) ''Member bank'' means any banking institution that is a member of the Federal Reserve System, including any subsidiary of a member bank. The term does not include any foreign bank that maintains a branch in the United States, whether or not the branch is insured (within the meaning of 12 U.S.C. 1813(s)) and regardless of the operation of 12 U.S.C. 1813(h) and 12 U.S.C. 1828(j)(3)(B).

(j) ''Person'' means an individual or a company.

(k) ''Principal shareholder''[6] means an individual or a company (other than an insured bank) that directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote more than 10 percent of any class of voting securities of a member bank or company. Shares owned or controlled by a member of an individual's immediate family are considered to be held by the individual. A principal shareholder of a member bank includes (1) a principal shareholder of a company of which the member bank is a subsidiary and (2) a principal shareholder of any other subsidiary of that company, exclusive of nonbank subsidiaries of member banks.

(*l*) ''Related interest'' means (1) a company that is controlled by a person or (2) a political or campaign committee that is controlled by a person or the funds or services of which will benefit a person.

(m) ''Subsidiary'' has the meaning given in section 2(d) of the BHC Act, but does not include a subsidiary of a member bank.

6. On October 28, 1992, in section 955 of the Housing and Community Development Act of 1992, Congress amended section 22(h) of the Federal Reserve Act to exclude from the definition of ''principal shareholder'' a company of which a member bank is a subsidiary. Regulation O was amended, effective December 17, 1992, to implement this change. As a result of the amendment, extensions of credit by a bank to its holding company and to any related interests of its subsidiary are governed solely by sections 23A and 23B of the Federal Reserve Act.

2050.0.3.2.1 Extension of Credit

For the purposes of Regulation O, an ''extension of credit'' is a making or renewal of any loan, a granting of a line of credit, or an extending of credit in any manner whatsoever, and includes—

(1) a purchase under repurchase agreement of securities, other assets, or obligations;

(2) an advance by means of an overdraft, cash item, or otherwise;

(3) issuance of a standby letter of credit (or other similar arrangement regardless of name or description) or an ineligible acceptance;

(4) an acquisition by discount, purchase, exchange, or otherwise of any note, draft, bill of exchange, or other evidence of indebtedness upon which an insider may be liable as maker, drawer, endorser, guarantor, or surety;

(5) an increase of an existing indebtedness, but not if the additional funds are advanced by the bank for its own protection for (i) accrued interest or (ii) taxes, insurance, or other expenses incidental to the existing indebtedness;

(6) an advance of unearned salary or other unearned compensation for a period in excess of 30 days; and

(7) any other similar transaction as a result of which a person becomes obligated to pay money (or its equivalent) to a bank, whether the obligation arises directly or indirectly, or because of an endorsement on an obligation or otherwise, or by any means whatsoever.

An extension of credit *does not* include—

(1) an advance against accrued salary or other accrued compensation, or an advance for the payment of authorized travel or other expenses incurred or to be incurred on behalf of the bank;

(2) a receipt by a bank of a check deposited in or delivered to the bank in the usual course of business unless it results in the carrying of a cash item for or the granting of an overdraft (other than an inadvertent overdraft in a limited amount that is promptly repaid under terms that are not more favorable than those offered to the general public).

(3) an acquisition of a note, draft, bill of exchange, or other evidence of indebtedness through (i) a merger or consolidation of banks or a similar transaction by which a bank acquires assets and assumes liabilities of another bank or similar organization, or (ii) foreclosure on collateral or similar proceeding for the protection of the bank, provided that such indebtedness is not held for a period of more than three years from the date of the acquisition, subject to

extension by the appropriate federal banking agency for good cause;

(4)(i) an endorsement or guarantee for the protection of a bank of any loan or other asset previously acquired by the bank in good faith or (ii) any indebtedness to a bank for the purpose of protecting the bank against loss or of giving financial assistance to it;

(5) indebtedness of $15,000 or less arising by reason of any general arrangement by which a bank (i) acquires charge or time credit accounts or (ii) makes payments to or on behalf of participants in a bank credit card plan, check credit plan, or similar open-end credit plan, provided—

(A) the indebtedness does not involve prior individual clearance or approval by the bank other than for the purposes of determining authority to participate in the arrangement and compliance with any dollar limit under the arrangement, and

(B) the indebtedness is incurred under terms that are not more favorable than those offered to the general public;

(6) indebtedness of $5,000 or less arising by reason of an interest-bearing overdraft credit plan (see Regulation O, section 215.4(e)); or

(7) a discount of promissory notes, bills of exchange, conditional sales contracts, or similar paper, without recourse.

Non-interest-bearing deposits to the credit of a bank are not considered loans, advances, or extensions of credit to the bank of deposit. Also, the giving of immediate credit to a bank upon collected items received in the ordinary course of business is not considered to be a loan, advance, or extension of credit to the depositing bank.

An extension of credit by a member bank (for the purposes of section 215.4 of Regulation O) is considered to have been made at the time the bank enters into a binding commitment to make the extension of credit. A participation without recourse is considered to be an extension of credit by the participating bank, not by the originating bank.

Tangible-economic-benefit rule. In general, an extension of credit is considered made to an insider to the extent that the proceeds are transferred to the insider or are used for the tangible economic benefit of the insider. An extension of credit is not considered made to an insider if—

(1) the credit is extended on terms that would satisfy the standard set forth in section 215.4(a) of Regulation O for extensions of credit to insiders; and

(2) the proceeds of the extension of credit are used in a bona fide transaction to acquire property, goods, or services from the insider.

2050.0.3.3 General Prohibitions and Limitations of Regulation O

(a) *Terms and creditworthiness*. No member bank may extend credit to any insider of the bank or insider of its affiliates unless the extension of credit (1) is made on substantially the same terms (including interest rates and collateral) as, and following credit-underwriting procedures that are not less stringent than, those prevailing at the time for comparable transactions by the bank with other persons that are not covered by Regulation O and who are not employed by the bank; and (2) does not involve more than the normal risk of repayment or present other unfavorable features.

Nothing stated above (as to ''terms and creditworthiness'') should prohibit any extension of credit made in accordance with a benefit or compensation program that—

1. is widely available to employees of the member bank, and in the case of extensions of credit to an insider of its affiliates, is widely available to employees of the affiliates at which that person is an insider; and

2. does not give preference to any insider of the member bank over other employees of the member bank and, in the case of extensions of credit to an insider of its affiliates, does not give preference to any insider of its affiliates over other employees of the affiliates of which that person is an insider.

(b) *Prior approval*. A member bank may not extend credit (including granting a line of credit) to any insider of the bank or insider of its affiliates in an amount that, when aggregated with the amount of all other extensions of credit to that person and to all related interests of that person, exceeds the higher of $25,000 or 5 percent of the member bank's unimpaired capital and unimpaired surplus, but in no event can it exceed $500,000. This provision applies unless (1) the extension of credit or line of credit has been approved in advance by a majority of the entire board of directors of that bank and (2) the interested party has abstained from participating directly or indirectly in the voting.

The board of directors' approval is not required for an extension of credit that is made pursuant to a line of credit that was approved by the board of directors within 14 months of the date of the extension of credit. Participation in the discussion, or any attempt to influence the voting, by the board of directors regarding an extension of credit constitutes indirect participation in the voting by the board of directors on an extension of credit.

(c) *Individual lending limit.* A member bank may not extend credit to any insider of the bank or insider of its affiliates in an amount that, when aggregated with the amount of all other extensions of credit by the member bank to that person and to all related interests of that person, exceeds the lending limit described above in section 2050.0.3.2 (paragraph h). This prohibition does not apply to an extension of credit by a member bank to a company of which the member bank is a subsidiary or to any other subsidiary of that company.

(d) *Aggregate lending limit.*

(1) *General limit.* A member bank may not extend credit to any insider of the bank or insider of its affiliates unless the extension of credit is in an amount that, when aggregated with all outstanding extensions of credit to all such insiders, would exceed the bank's unimpaired capital and unimpaired surplus as defined in section 215.2(i) of Regulation O (see section 2050.0.3.2, paragraph h).

(2) A member bank with deposits of less than $100,000,000 may by an annual resolution of its board of directors increase the general limit (specified above) to a level that does not exceed two times the bank's unimpaired capital and unimpaired surplus if the board of directors determines that such higher limit is consistent with prudent, safe, and sound banking practices in light of the bank's experience in lending to its insiders and is necessary to attract or retain directors or to prevent the restriction of the availability of credit in small communities.

The board of directors' resolution must set forth the facts and reasoning on which it bases its finding, including the amount of the bank's lending to its insiders as a percentage of the bank's unimpaired capital and unimpaired surplus as of the date of the resolution. In addition, the bank must meet or exceed, on a fully phased-in basis, all applicable capital requirements established by the appropriate federal banking agency. The bank would also have had to receive a satisfactory composite rating in its most recent bank examination report.

If a member bank has adopted a resolution authorizing a higher limit and subsequently fails to meet the above-listed requirements, the member bank cannot extend any additional credit (including a renewal of any existing extension of credit) to any insider of the bank or its affiliates unless the extension or renewal is consistent with the general limit.

(3) *Exceptions to the general limit.* Effective May 3, 1993, the general limit, described in manual section 2050.0.3.3 (paragraph d) and specified in section 215.4(d)(1) of the Board's Regulation O does not apply to—

(i) extensions of credit secured by a perfected security interest in bonds, notes, certificates of indebtedness, or Treasury bills of the United States or in other such obligations fully guaranteed as to principal and interest by the United States;

(ii) extensions of credit to or secured by unconditional takeout commitments or guarantees of any department, agency, bureau, board, commission, or establishment of the United States or any corporation wholly owned directly or indirectly by the United States;

(iii) extensions of credit secured by a perfected security interest in a segregated deposit account in the lending bank; or

(iv) extensions of credit arising from the discount of negotiable installment consumer paper that is acquired from an insider and carries a full or partial recourse endorsement or guarantee by the insider,[7] provided that—

(A) the financial condition of each maker of such consumer paper is reasonably documented in the bank's files or known to its officers;

(B) an officer of the bank designated for that purpose by the board of directors of the bank certifies in writing that the bank is relying primarily upon the responsibility of each maker for the payment of the obligation and not upon any endorsement or guarantee by the insider; and

(C) the maker of the instrument is not an insider.

(e) *Overdrafts.* A member bank may not pay an overdraft of an executive officer or director of the bank[8] on an account at the bank, unless the payment of funds is made in accordance

7. The exceptions to the aggregate lending limit pertaining to extensions of credit secured in the manner described above (i through iii) apply only to the amounts of such extensions of credit that are secured in such manner.

8. This prohibition does not apply to the payment by a member bank of an overdraft of a principal shareholder of the member bank, unless the principal shareholder is also an executive officer or director. This prohibition also does not apply to the payment by a member bank of an overdraft of a related interest of an executive officer, director, or principal shareholder of the member bank.

with (1) a written, preauthorized, interest-bearing extension of credit plan that specifies a method of repayment; or (2) a written, preauthorized transfer of funds from another account of the account holder at the bank.

The prohibition above does not apply to payment of inadvertent overdrafts on an account in an aggregate amount of $1,000 or less, provided (1) the account is not overdrawn for more than five business days; and (2) the member bank charges the executive officer or director the same fee charged any other customer of the bank in similar circumstances.[8a]

2050.0.3.4 Additional Restrictions on Loans to Executive Officers of Member Banks

The following restrictions on extensions of credit by a member bank to any of its executive officers are in addition to any restrictions on extensions of credit by a member bank to insiders of itself or its affiliates. The restrictions listed below apply only to the executive officers of the member bank and not to the executive officers of its affiliates.

A member bank may not extend credit to any of its executive officers, and no executive officer of a member bank can borrow from or otherwise become indebted to the bank, except in the amounts, for the purposes, and upon the conditions specified in items 3 and 4 below.

A member bank is authorized to extend credit to any executive officer of the bank—

(1) in any amount to finance the education of the executive officer's children;

(2) in any amount to finance or refinance the purchase, construction, maintenance, or improvement of a residence of the executive officer, provided—

(i) the extension of credit is secured by a first lien on the residence and the residence is owned (or expected to be owned after the extension of credit) by the executive officer; and

(ii) in the case of refinancing, that only the amount used to repay the original extension of credit, together with the closing costs of the refinancing, and any additional amount thereof used for any of the purposes enumerated in item 2 above, are included within this category of credit;

(3) in any amount, if the extension of credit is secured in a manner described in the first three exceptions to the general limit of the aggregate lending limit (see section 2050.0.3.3, paragraph d, subparagraphs i to iii); and

(4) for any other purpose (not specified in items 1 through 3 above), if the aggregate

8a. The requirement that the member bank charge the executive officer or director the same fee charged any other customer of the bank in similar circumstances does not prohibit the member bank from charging a fee provided for in a benefit or compensation program that satisfies the requirements detailed in section 2050.0.3.3, item (a).

amount of loans to that executive officer does not exceed, at any one time, the higher of 2.5 percent of the bank's unimpaired capital and unimpaired surplus or $25,000, but in no event more than $100,000.

Any extension of credit by a member bank to any of its executive officers must be—

(1) promptly reported to the member bank's board of directors;

(2) in compliance with the general prohibitions of section 215.4 of Regulation O (manual section 2050.0.3.3);

(3) preceded by the submission of a current detailed financial statement of the executive officer; and

(4) made subject to the condition in writing that the extension of credit will, at the option of the member bank, become due and payable at any time that the officer is indebted to any other bank or banks in an aggregate amount greater than the amount specified for a category of credit that may be made available by a member bank to any of its executive officers.

No member bank may extend credit in an aggregate amount greater than the amount permitted for general-purpose loans to an executive officer (section 215.5(c)(4) of Regulation O) to a partnership in which one or more of the bank's executive officers are partners and, either individually or together, hold a majority interest. The total amount of credit extended by a member bank to such partnership is considered to be extended to each executive officer of the member bank who is a member of the partnership.

Prohibition on knowingly receiving unauthorized extensions of credit. Insiders are prohibited from knowingly receiving (or permitting their related interests to receive) any extensions of credit not authorized by section 22(h) of the Federal Reserve Act and by Regulation O.

2050.0.3.5 Grandfathering Provisions

(a) *Under FDICIA.* FDICIA provided that the amendments to Regulation O would not affect extensions of credit entered into on or before the effective date of the regulation. Therefore, extensions of credit, including lines of credit, made on or before May 18, 1992, are not required to comply with either the individual-borrower limit made applicable to directors and their related interests, or with the aggregate limit on all loans to insiders. All extensions of credit, loan renewals, and loan rollovers made after May 18, 1992, must comply with all of the provisions of Regulation O. In other words, banks cannot make new loans or renew outstanding extensions of credit in amounts that, when aggregated with all other outstanding loans to insiders, would exceed either of the new limits.

(b) *Extensions of credit outstanding on March 10, 1979.* Any extension of credit that was outstanding on March 10, 1979, and that would have, if made on or after March 10, 1979, violated the individual lending limit, had to be reduced in amount by March 10, 1980, to be in compliance with the aggregate lending limit of Regulation O. Any renewal or extension of such a credit extension on or after March 10, 1979, must have been made only on terms that would have brought it into compliance with the aggregate lending limit by March 10, 1980. However, any extension of credit made before March 10, 1979, that bears a specific maturity date of March 10, 1980, or later, had to be repaid in accordance with the repayment schedule in existence on or before March 10, 1979.

2050.0.3.6 Reports by Executive Officers

Each executive officer of a member bank who becomes indebted to any other bank or banks in an aggregate amount greater than the amount specified for a category of credit in section 215.5(c) of Regulation O (manual section 2050.0.3.4) must make a written report to the board of directors of the officer's bank within 10 days of the date the indebtedness reaches such a level. The report must state the lender's name, the date and amount of each extension of credit, any security for it, and the purposes for which the proceeds have been or are to be used.

Report on credit secured by BHC stock. In addition to the report required above, each executive officer or director of a member bank the shares of which are not publicly traded must report annually to the bank's board of directors the outstanding amount of any credit that was extended to the executive officer or director that is secured by shares of the member bank. (See also Regulation Y section 225.4(f) for the identical restriction on executive officers and directors of a bank holding company with loans secured by shares of the bank holding company.)

2050.0.3.7 Report on Credit to Executive Officers

Each member bank must include with (but not as part of) each report of condition (and copy thereof) filed pursuant to 12 U.S.C. 1817(a)(3) a report of all extensions of credit made by the member bank to its executive officers since the date of the bank's previous report of condition.

2050.0.3.8 Disclosure of Credit from Member Banks to Executive Officers and Principal Shareholders

(a) *Definitions.* For the purposes of this section, the following definitions apply:

(1) ''Principal shareholder of a member bank'' means a person (individual or a company), other than an insured bank, or branch or representative office of a foreign bank as defined in 12 U.S.C. 3101(7)[9] that, directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has power to vote more than 10 percent of any class of voting securities of the member bank or company. The term includes an individual or company that controls a principal shareholder (for example, a person that controls a bank holding company). Shares of a bank (including a foreign bank), bank holding company, or other company owned or controlled by a member of an individual's immediate family are considered to be held or controlled by the individual for the purposes of determining principal shareholder status.[10]

(2) ''Related interest'' means (i) any company controlled by a person; or (ii) any political or campaign committee the funds or services of which will benefit a person or that is controlled by a person. A related interest does not include a bank or a foreign bank (as defined in 12 U.S.C. 3101(7)).

(b) *Public disclosure.* Upon receipt of a written request from the public, a member bank shall make available the names of each of its executive officers (with the exception of any executive officer of a bank holding company of which the member bank is a subsidiary or of any other subsidiary of that bank holding company unless the executive officer is also an executive officer of the member bank) and each of its principal shareholders to whom, or to whose related interests, the member bank had outstanding at the end of the latest previous quarter of the year, an extension of credit that, when aggregated with all other outstanding extensions of credit at that time from the member bank to such person and to all related interests of such person, equaled or exceeded 5 percent of the member bank's capital and unimpaired surplus or $500,000, whichever amount is less. No disclosure under this paragraph is required if the aggregate amount of all extensions of credit outstanding at that time from the member bank to the executive officer or principal shareholder of the member bank and to all related interests of such a person does not exceed $25,000.

A member bank is not required to disclose the specific amounts of individual extensions of credit.

(c) *Maintaining records.* Each member bank is required to maintain records of all requests for the information described above and the disposition of the requests. These records may be disposed of two years after the date of the request.

2050.0.3.9 Civil Penalties of Regulation O

Any member bank, or any officer, director, employee, agent, or other person participating in the conduct of the affairs of the bank, that violates any provision of Regulation O is subject to a civil penalty, as specified in section 29 of the Federal Reserve Act.

2050.0.3.10 Records of Member Banks (and BHCs)

To help inspection and examination personnel identify BHC officials, Regulation O requires each member bank to maintain records necessary to monitor compliance with this regulation. BHCs and nonbank subsidiaries should be given access to the records identifying ''bank officials.'' Each state member bank is required to (1) identify, through an annual survey, all insiders of the bank itself; and (2) maintain records of all extensions of credit to insiders of the bank itself, including the amount and terms of each such extension of credit.

9. A ''foreign bank'' means any company organized under the laws of a foreign country, a territory of the United States, Puerto Rico, Guam, American Samoa, or the Virgin Islands that engages in the business of banking, or any subsidiary or affiliate, organized under such laws, of any such company. This includes foreign commercial banks, foreign merchant banks, and other foreign institutions that engage in banking activities usual in connection with the business of banking in the countries where such foreign institutions are organized or operating.

10. See footnote 3.

2050.0.3.10.1 Recordkeeping for Insiders of the Member Bank's Affiliates

A member bank is required to maintain records of extensions of credit to insiders of the member bank's affiliates by:

(1) A "survey" method, which identifies, through an annual survey, each of the insiders of the member bank's affiliates. Under the survey method, the member bank must maintain records of the amount and terms of each extension of credit by the member bank to such insiders; or

(2) A "borrower inquiry" method, which requires, as part of each extension of credit, the borrower to indicate whether the borrower is an insider of an affiliate of the member bank. Under this method, the member bank must maintain records that identify the amount and terms of each extension of credit by the member bank to borrowers so identifying themselves.

Alternative recordkeeping method for insiders of affiliates. A member bank may use a recordkeeping method other than those identified above if the appropriate federal banking agency determines that the bank's method is at least as effective.

2050.0.3.10.2 Special Rule for Noncommercial Lenders

A member bank that is prohibited by law or by an express resolution of the bank's board of directors from making an extension of credit to any company or other entity that is covered by Regulation O as a company is not required to maintain any records of the related interests of the insiders of the bank or its affiliates or to inquire of borrowers whether they are related interests of the insiders of the bank or its affiliates.

2050.0.3.11 Section 23A Ramifications

Loans to a holding company parent and its affiliates are governed by section 23A of the Federal Reserve Act and are not subject to Regulation O.

2050.0.4 REMEDIAL ACTION

Self-serving and abusive transactions deprive a BHC of opportunities and benefits that may otherwise have been available and may strip a BHC of its ability to serve as a source of financial and managerial strength to its subsidiary banks. Even if not extended on preferential terms, self-serving loans and other extensions of credit to insiders may be an imprudent business practice and may reduce the lender's liquidity or otherwise overextend the BHC. In such situations, formal or informal remedial measures by the Federal Reserve may be necessary. Formal enforcement action is provided for in the 1974 amendments to the Financial Institutions Supervisory Act of 1966 (12 U.S.C. 1818), which grant the Board authority to issue cease-and-desist orders in appropriate situations. For complete details on formal corrective actions, see section 2110.0.

2050.0.5 INSPECTION OBJECTIVES

1. To determine if any transactions between BHC officials, their related interests, and the BHC or its nonbank subsidiaries are based on preferential treatment.
2. To determine if any transactions between BHC officials, their related interests, and the BHC or its nonbank subsidiaries result in any undue loss exposure to the BHC or its subsidiaries.
3. To determine if any BHC or nonbank extension of credit to a BHC official or related interest is in the spirit of Regulation O's requirements or whether it is an attempt to circumvent Regulation O's prohibition on various bank extensions of credit to similar parties.
4. To determine that BHC officials are aware of Regulation O's limitations and prohibitions and have established internal policies and procedures for the bank subsidiaries to ensure compliance by the banks.
5. To determine that the BHC has arranged to make available, upon request, a listing or some other form of information sufficient to identify all "BHC officials" and to make certain that such information is available to the bank subsidiaries in particular.

2050.0.6 INSPECTION PROCEDURES

1. Review the balance sheets and other records of the parent-only and nonbank subsidiaries to determine if there are any loans or other extensions of credit to BHC officials.
2. Review the income statements and supporting records of the parent-only and nonbank

subsidiaries to determine if any interest income, other income, or expense is associated with a transaction with a BHC official or a related interest.

3. Ask management to identify all such transactions and to provide supporting documentation.

4. Review management's familiarity with Regulation O's limitations and the steps they have taken to establish policies for the internal administration of their subsidiary banks' extensions of credit to BHC officials.

5. Review any information prepared by management that presents a listing of all BHC officials and their related interests.

6. Review any corporate resolutions declaring an individual not to be an ''executive officer'' for purposes of Regulation O and, if necessary, confirm the individual's nonparticipation in the formulation of corporate policy.

2050.0.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Loans and extensions of credit to executive officers, directors, and principal shareholders	375a and 375b (sections 22(g) and 22(h) of F.R. Act)	215.4 215.5 (Reg. O)		
Granting of below-market interest rate mortgage loans to executives of BHC subsidiaries as compensation			4–514 3–1094	
Loans from correspondents		215.22 215.23		
Loans to correspondents	1972	215.20		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.